PR24

PR24 and beyond: Creating tomorrow, together

July 2021

United Utilities response to Ofwat's May 2021 consultation on PR24 and beyond

United Utilities

Water for the North West

Executive Summary

United Utilities Water is pleased to respond to Ofwat's consultation on "Creating tomorrow, together" through PR24. We support a progressive regulatory framework, which incentivises companies to deliver great outcomes for customers and the environment. The 2024 price review needs to provide both a platform for ambitious performance targets and sufficient resources such that companies are able to deliver service and resilience improvements for the long-term.

UUW intends to propose an efficient and innovative plan with stretching targets for service delivery. As a purpose led company, we focus on what matters to our stakeholders and we want the forthcoming price review to support us in achieving our aims. Our purpose is to deliver great water and more for the North West. This means leading the way on service for core water, wastewater and customer services and delivering value to stakeholders including customers, the environment, our employees and suppliers, all whilst securing the necessary financial resources for investment by delivering a sustainable return to investors.

We look forward to contributing further to the development of the PR24 methodology and framework over the coming months. Key points that we would highlight in our response are:

- We support Ofwat's proposed key themes and believe that focussing on these can positively support the sector in tackling the changing and growing depth and breadth of challenges that arise from climate change, the pandemic, decarbonisation and other emerging issues. We believe that the sector needs to respond to the changed landscape in the best interests of customers both today and into the future, delivering ongoing affordability and improved resilience both in AMP8 and the longer term.
- We welcome Ofwat's intention to improve clarity of the long-term regulatory framework. Of the options presented, we support the second proposal - to provide indicative "levels" for service and incentives as a benchmark for future reviews. This provides a more appropriate balance of certainty vs flexibility than either the more rigid approach of fixing long-term targets or the weaker approach of setting out only high-level guidance of how Ofwat might approach the targets in future.
- We will support a more collaborative and national approach to customer research and contribute expertise and resources to this effort. However, the challenges Ofwat will face in delivering high quality research for each company service area - and doing so on a timely basis - will be significant and should not be underestimated. These results are essential and fundamental parts of business plan development and we would underline the real need to clarify soon the ownership, timescales and deliverables for this work. Our clear view is that we should work to resolve this question within the next few months in order to allow companies the best possible opportunities to execute a business planning process that supports us in delivering the best outcomes for customers and other stakeholders.
- We welcome the recognition of the need for greater co-ordination in development of plans reflecting the multiple parallel processes and strategic planning frameworks that need to be reflected in PR24. A key contribution from Ofwat towards making this process work better is for it to provide transparent feedback as early as possible in these planning cycles so that this can be reflected in business planning. As set out in our contribution to the Future Ideas Lab, we champion the need for WINEP reform and believe that all actors in the sector have a part to play in maximising the success that an outcomes focus can bring. We believe that achieving more flexibility through this approach will ensure that these key investments deliver effectively and efficiently with consideration for the needs of the air, land and water environment in balance with social needs and concerns such as affordability.
- We also believe that there needs to be increased recognition that additional contingent arrangements will be required at PR24 than was the case at either PR19 or PR14. This is particularly true given uncertainties over the development and evolution of the WINEP. We believe the WINEP

mechanism at PR19 provides a sound basis to build upon for PR24, although its use is likely to more material in AMP8 than in AMP7.

- We support nature based catchment solutions and partnership working to support efficient, less carbon intensive delivery of services. The price review process needs to better accommodate such schemes if they are going to be widely adopted. In particular, there needs to be recognition that this form of delivery implies a lower degree of certainty associated with costs and outputs than is associated with traditional solutions. Setting the evidential hurdles as strictly equivalent will likely result in a bias towards tried and tested approaches. Instead, there should be an acknowledgement that "in the round" best outcomes for customers and the environment might best be achieved by considering the broader potential benefits from innovative, nature based, catchment and partnership approaches and that the potential long-term rewards may outweigh the inevitable reduction in certainty compared to the traditional solution. We also wish to support an approach that provides an effective assessment and valuation of carbon impacts through the business planning process, reflecting its growing importance to customers and stakeholders as a key outcome.
- We agree with retention of the overall building blocks, which comprise Ofwat's price review approach. We do not believe that simplification of the price review should be pursued as an end in and of itself. This is especially the case given the large number of stakeholders and external influences the price review needs to be responsive to and that an approach that prioritises simplification would tend to obscure the changes to risk allocation that result.
- We are supportive of Ofwat publishing a timetable that the industry can rely upon and align to. This was one of the significant successes of PR19 and we welcome Ofwat's indication that it intends to provide early guidance on a broader range of metrics than at PR19. We believe that the timetable needs substantial further development in the near term, and certainly significantly ahead of the draft methodology publication in a year's time. For example, we note that early submissions from companies are expected in May 2023, but we do not have visibility of the scope or content of these.
- We support the concept of targeted challenges as a means of driving greater focus on key issues where a step change is required. It will be important, however, for these to be specified in a way which drives the most efficient and effective use of customers' money rather than pursuing a flawed measure. Likewise, the additional costs associated with meeting the challenge need to be properly resourced through the price review process including through cost allowances where justified. Targeted challenges of the type described by Ofwat are not deliverable "for free" either in regulated or unregulated markets; they represent an additional stretch for any organisation and in turn require additional focus and resources for delivery.
- We support Ofwat's desire to consider further ways of incentivising financial resilience to protect customers from the adverse outcomes of risky financial structures. Rather than focus on negative incentives for highly geared companies, we believe that a positive incentive mechanism for companies with lower levels of gearing would be more effective in incentivising companies to have higher levels of financial resilience. With this in mind, the proposal to adjust the notional gearing assumption would be more detrimental to those companies currently seen as compliant, as those with higher levels of gearing would not likely suffer any relative change.

We hope that our response to the consultation is useful, especially when taken together with the papers we have contributed to Ofwat's Future Ideas Lab and which we will build upon further in the coming months. We would welcome the opportunity to discuss these issues with you further at the earliest opportunity.

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2. Ambitions for PR24

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

We support the four proposed themes as areas where the price review can help drive improvements through the design of PR24.

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

We welcome Ofwat's desire to increase the clarity of its long-term regulatory framework although acknowledge the inherent trade-offs of seeking to provide clarity whilst retaining the ability to adapt to changes. Long-term objectives can be better pursued and incentivised through a multi-AMP approach. However, we do not believe that it would be appropriate or realistic for Ofwat to attempt to fix parameters over several periods and instead see more value in an approach, which provides indicative levels and guidance on the intended approach to future reviews. This might also then act to reduce the regulatory burden at future reviews if changes to the initial assumptions are not required/minimal, hence delivering another of Ofwat's aims.

In looking to address the level of complexity within the price control, we agree that Ofwat should not seek to simplify areas just for the sake of simplification. Aspects of the price control have become increasingly complex quite simply because they need to be and stakeholders would rightly question simplification which leads to a significant loss of precision. PR24 also needs to reflect and take account of many external influences including:

- The Government's Strategic Policy Statement;
- Relevant findings from recent regulatory decisions and CMA appeals; the WINEP – the timing of which presents some particular issues; and,
- New statutory processes such as the DWMP, and earlier delivery of established processes such as the WRMP.

This is particularly challenging for a price review that is already complex. It therefore seems likely to us that PR24 will likely need to recognise a greater degree of contingent items – i.e. mechanisms the manage that uncertainty in an appropriate and robust manner.

Finally, we agree with Ofwat that it is vital that the price control framework continues to reflect local and national diversity, particularly as we move towards greater standardisation of outcomes and incentives.

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

It is important that Ofwat sets a clear timetable and endeavours to deliver to it. This is especially important given Ofwat's intention to publish a greater degree of business plan guidance to be reflected in business plans. Adherence to a well-defined timetable was very supportive of the PR19 process and we would encourage Ofwat to continue with the same approach for PR24. In view of the additional emphasis companies are expected to put on Ofwat-sourced data before plan submission, it is important to ensure that the risk of late or under-delivery is minimised.

3. How we regulate

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

We agree with the retention of the building block approach – it has served well in the past and is well understood by investors and other stakeholders.

What is more important is Ofwat's approach to those building blocks. We note that, in many areas, Ofwat is seeking to increasingly standardise each company's price control (e.g. the increased focus on common performance commitments) but we believe it is important to recognise that there are genuine regional differences between the different regions of England and that these should be reflected in the review. The best price review outcomes for customers will be achieved where determinations take account of differences in company regions, demographics, operating environments and investment requirements.

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

Coordination across the sector is important for water resources because more water transfers and jointly developed resources are likely to be cost effective and resilient ways of meeting very significant needs for new resources in parts of England. The sector has transformed the way it is working through the establishment of regional water resources groups, which are working collaboratively across sectors and across regions. United Utilities is proactively providing leadership for Water Resources West. The regions are supported by RAPID and the National Framework for water resources. The collaborative and coordinated approach is new and should be supported through PR24 before further coordination measures are considered. This will allow further coordination measures to be considered in light of experience of regional planning through PR24. Ofwat can support this coordination by continued engagement with the regions, providing early challenge to regional water resources plans as they develop through the stages of consultation.

Coordination for water resources is also important beyond the strategic planning phase, which we highlighted in our 2017 joint working paper with Severn Trent and Thames Water. We are pleased that Ofwat is considering the issue of coordinated operation and commercial models with sector representatives through RAPID working groups. We will continue to support this work. In addition to this, there may be more value in having greater sector coordination on common ambitions such as water efficiency, for example, through national campaigns and targeted engagement, rather than each working separately within their own regions. Furthermore, there might also be opportunities to engage with other sectors, such as energy, that have similar ambitions and learn lessons from previous engagements in order to maximise the value that can be delivered for customer, across all services.

In the case of wastewater, there is less obvious benefit to wider coordination between companies because it is expensive to transfer wastewater any distance. There is, however, the potential to utilise markets to take recycled products from wastewater/sludge that would lend themselves to transportation thereby driving more of a circular economy. As part of the Ofwat innovation competition, we are leading a project to establish opportunities for industrial symbiosis in the North West of England. If successful this will provide a template that can be adapted for the wider UK water sector.

We also believe there are significant opportunities to be gained from Catchment System Operation coming into being in terms of addressing flood risk, water quality, biodiversity recovery and resilient water resources. These issues cross the boundaries of many organisations' responsibilities and interests. More integrated planning and operation can therefore support their aims. In the meantime, we believe there are opportunities to develop more partnership based solutions, which deliver multiple benefits. These types of projects take time to develop and agree as it involves aligning understanding of risks and opportunities as well as funding sources across multiple organisations. As a result, we propose that a flexible mechanism to drive the ongoing innovation and development of these schemes during the AMP will be important as it is very unlikely that all opportunities can feasibly developed during the price review period.

4. Increasing focus on the long-term

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

We agree and support Ofwat's view that it is important for water companies to plan using a long-term context. We also recognise that long-term plans need reviewing and adjusting from time to time to accommodate external changes (e.g. new innovations, changes in customer expectations, socio-political climate etc.). We note that there are two ways of looking at the long-term, each of which need to be reflected at PR24:

- Having long-term ambitions and setting five-year targets within those goals. For this, Ofwat will need to recognise that many of its comparative assessments are informed by reviewing historic industry performance and setting benchmarks relative to short-term company performance. A forward-looking context (e.g. reflecting climate change, etc.) should recognise that in the future, continuing to benchmark companies based on trends in historic performance might not be either feasible or desirable. If there is not sufficient understanding of the drivers of prior performance; whether it has been driven by interventions or exogenous factors, it might risk setting an unrealistic future target in the round.
- Measuring long-term performance should make far greater use of forward looking, leading measures (e.g. risk assessments) rather than focussing on short term lagging measures, which only reflect recent history. However, Ofwat's approach to common performance commitments to date has focused almost solely on simple lagging measures. We recognise that leading measures are harder to evaluate and can be more subjective, and may therefore confer additional regulatory risk onto Ofwat – however, adoption of such approaches is an essential part of giving proper consideration to the long-term future.

We would note that the need for greater focus on how the sector will deliver for the long-term isn't just something for companies to set out in their business plans, it is equally important that the regulatory framework provides the right incentives and clarity to facilitate these improvements. We cover this further in Q4.8 and Q10.4.

Q4.2 What should long-term strategies seek to cover and what details should we expect companies to set out in business plans? Would common requirements would help us and other stakeholders to understand each company's approach?

We see there being a number of considerations in developing long-term plans within the price control:

- Five-year targets for service should be set within the context of a long-term ambition – Ofwat should specify the duration of that ambition to support comparability. We would propose these align to the timescales of the respective statutory planning frameworks. We note that this cannot be more than an ambition given degree of uncertainty, but each company should set out its broad expectations.
- Common planning assumptions are an important aid to comparability. Without a coordinated approach, the assumption sets and forecasts will be different which could lead to incorrectly assigning different levels of ambition to plans (for example, PR19 showed how diverse companies could be in addressing the same question). This should include climate change impacts (temperature and rainfall), growth in new developments, population forecasts and importantly, an assumption on the future cost of carbon.

Validated assumptions are currently utilised across existing planning frameworks, such as WRMP, DWMP and Price Reviews to ensure robust plans are developed which can stand up to scrutiny and provide consistency across the industry. Within WRMP and DWMP, there are specific guidelines as to which data sources should be used to create an assumption. However, as these are guidelines and not instructions there is opportunity for companies to deviate from them. Therefore, establishing common assumptions that are mandated to be used in planning cycles would create greater consistency and a level playing field. We would welcome the existing guidelines to become mandated where feasible in readiness for PR24, however some flexibility may need to be considered for areas such as DWMP where the impact of re-running large numbers of network models will make this impractical.

We see an opportunity for a sector-wide position on common assumptions to be informed by the in-flight UKWIR Research Project on 'Future Asset Planning' which aims to create common approaches to scenario planning, value frameworks and asset health measures across the industry; and is actively engaging representatives from across the sector. This will conclude in December 2021.

- In addition, if Ofwat wishes to reduce the focus on the short-term, then it may be beneficial to provide its own longer term projections of future parameters that it expects to use in future reviews.
- Some areas of company plans could be covered by existing frameworks (WRMP, DWMP etc.), whereas others may not (e.g. Water networks, Bioresources). It would be appropriate to clarify which components of company plans can be defined within those existing frameworks, and which will need separate consideration.
- The WINEP drives around £1bn of investment across the industry in England each year. As a result, it is important that the planning for it be fully integrated into the industry's long-term planning. Whilst steps are being made towards this for PR24 through WINEP reform, which is likely to increase the water companies' role in development of the WINEP, it will not be fully achieved until the WISER and WINEP driver guidance are produced earlier in the price review cycle such that they can influence the development of WRMP and DWMP. The development of long-term targets for the Environment Bill is also likely to be a positive step to address this issue.

We also envisage that long-term plans will be specific to each company, reflecting the regional priorities and challenges faced by each company.

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

At present, the outcomes of strategic planning work (such as WRMP) are considered by Ofwat as part of the price control process. Whilst we recognise Ofwat's role in ensuring that company interventions are both necessary and efficient, the separation of the price review assessment from development of the strategic plans can create some uncertainty.

Given the acceleration of the WRMP process (whereby company plans are submitted prior to the conclusion of the WRMP process), it would seem more appropriate for Ofwat to be more engaged and involved during the preparation of the WRMP. Ofwat's role suggests that it should be a key stakeholder in the WRMP and fully engaged in the process. This is even more important for the DWMP given it is a new framework and therefore is likely to result in a range of different approaches from companies.

Q4.4 How can we allow such strategies and plans to adapt to new information at future reviews while continuing to hold companies to account to deliver expected benefits into the future?

We see this as one of the key purposes of the periodic review process. It should be an opportunity to collect and review information that is pertinent to company long-term strategies (external influences etc.) and to balance these between setting challenging future expectations, monitoring company historic performance, and adjusting long-term ambitions, as appropriate.

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

This could be beneficial to the process, but care will need to be taken to provide timely execution of the expected data and pre-defined scope. It will be essential that:

- Ofwat is clear about what it intends to publish – if the publication is to support the process then companies will need to plan around Ofwat's publication, based on a clear understanding of what will (and will not) be covered under Ofwat's remit and – therefore – what companies should focus on as their core contributions to the price review.

- The publication must be published early enough to allow reasonable time for the company to include in their plans, and hence to undertake sufficient governance and engagement on its plans.

For example, we note that Ofwat's deadline for "early submissions" from companies for PR24 is in May 2023, less than 2 years away. It is unclear what information Ofwat anticipates companies will submit at this stage, but if it involves responding to data or guidance to be published by Ofwat then this needs to be provided, at a minimum, 12 months beforehand to allow companies time to reflect on the information, incorporate it into plans and submissions and undertake comprehensive assurance processes.

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

UUW does not operate to any significant extent in Wales and so we do not wish to comment on what might be the best approach for customers in Wales. However, we would observe that customers in the North West region – and indeed in different sub-regional areas of the North West – have distinctive needs and local views about services and priorities. It is not obvious to us that a collaborative approach to developing regional plans in England is any less feasible or desirable than the collaborative approach being tentatively explored by Ofwat for Wales. Furthermore, if it is perceived that a collaborative approach offers benefits to customers in Wales then we believe it is important to explore whether a similar approach could deliver similar benefits for customers in the North West or sub-regional areas of the North West.

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

Making improvements in long-term planning requires clarity on future expectations, including those of regulators. We tend to support the approach that would specify "indicative levels" for performance in advance (rather than less flexible fixed/immovable targets or more high-level statements about how Ofwat might go about setting such targets in the future.) However, if these indicative levels are to be reflected in company plans, then these expectations would need to be provided soon, to give time for companies to build plans that appropriately incorporate those expectations.

Long-term planning also benefits from a more stable and predictable regulatory framework. It would therefore also be helpful for Ofwat to be clear about the future trajectory of both performance levels and the value of incentives – significant changes to either of these will likely lead to companies making, in hindsight, the wrong interventions in the short term. We note that there are some indications of significant changes given Ofwat's early views on PR24, compared with the previous two reviews, for example:

- At PR14 Ofwat made very significant changes to the price control framework.
- Ofwat was clear at PR19 that an objective was to apply incentives as a revenue adjustment as close as possible to observing company performance, whereas for PR24 Ofwat is considering deferring the application of incentives in order to ascertain whether performance is sustained.
- At PR14 and PR19 Ofwat set an outcomes framework that encapsulated a mix of common and bespoke measures, whereas for PR24 Ofwat appears to wish to reduce the use of bespoke measures.

Changes to the balance of incentives make it more difficult for companies to formulate and deliver long-term plans. Increased visibility in the framework could provide greater opportunity for plans to be built based on a multi-AMP approach.

Long-term planning would be better supported by:

- Ofwat shifting its focus onto more leading measures, and reducing its focus on short-term lagging measures of performance. This could include standardised risk assessments in key areas, such as resilience – UUW proposed an approach for such measures as part of its PR19 representations[1].
- Ofwat being more permissive of companies providing longer-term incentive commitments to customers. For example, the ability to provide multi-AMP assurances on charging incentives could give greater stimulus for behavioural change by customers and support their business case for investment in green infrastructure or water reuse schemes.

We don't support the idea that rewards should be held back to future periods as this tends to devalue the power of those incentives relative to the time that companies are acting in response to those incentives.

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

Ofwat should consider how it can remove barriers to partnership schemes and nature based solutions, which better deliver environmental and social value. These types of schemes are inherently uncertain, both in the final cost requirements and benefits delivery. This is due to the nature of such schemes, whereby what is deliverable is largely revealed through the partnership process – therefore it is significantly less certain what will be delivered up front. However, a traditional price control process tends to favour traditional solutions, seeking up front certainty in both the cost and service improvements that are planned. This certainly helps facilitate performance monitoring but it can also act as a barrier to partnership delivery of greater environmental and social value.

- In the Green Recovery process, UUW proposals for partnership schemes required far greater volumes of written evidence, for the value delivered, given the level of uncertainty, up front delivery commitments with an equivalent expectation of certainty as for traditional solutions and, when future uncertainty was still observed, an efficiency haircut was proposed at the draft determination stage which was not imposed in areas with more traditional solutions.

To build confidence that plans which fully embrace partnership solutions are capable of being accepted by Ofwat we believe that a fresh approach needs to be taken to evaluating proposals, incentivising delivery and promoting them in preference to traditional solutions.

We understand Ofwat's view that companies are principally funded by customers to deliver statutory obligations, but believe that there is still scope to offer more support to companies pursuing broader delivery of additional social and environmental value and for this to be reflected in the price determination process. Additionally, there may not be buyers of the societal goods so whilst we may have a "best value" solution, it may not be deliverable due to the lack of buyers of the added value services e.g. biodiversity. This may mean we have to default to the lowest whole life cost scheme. We need the government to push buyers to market through either enforcing regulation or economic incentives otherwise very worthwhile schemes will not be delivered.

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

Whilst the regulatory framework has evolved since privatisation to deliver service and efficiency improvements, there are some evolutionary changes that we believe would help provide additional focus on the long-term. This could be particularly useful for accommodating climate change, net zero carbon and demographic changes or other similar drivers. These are:

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[1] https://www.unitedutilities.com/globalassets/z_corporate-site/about-us-pdfs/looking-to-the-future/measuring-resilience-in-the-water-industry_final.pdf

- identifying the appropriate framework for companies to submit the case for additional allowances resulting from changing requirements and service expectations; and,
- a development of the outcomes framework to incentivise appropriate increases in asset health investment.

It would be beneficial for Ofwat to identify the appropriate framework for cost adjustments to account for increasing service expectations and drivers for change. This could be a new framework or an adaptation of the previous cost adjustment claim as utilised for PR14 and PR19. Without a consistent approach, Ofwat risks companies presenting the cases inconsistently, increasing the burden of work for Ofwat and ultimately, making the process less transparent and comparable. It could be supplemented by Ofwat's recently completed asset management capability assessment. This would help to ensure that any provision for increased investment was coupled to an assurance of competent asset management. The framework could define the appropriate level of evidence of investment needs and the business competencies underpinning the company's assessment of those needs.

We would also like to see development of asset health performance commitments and associated outcome delivery incentives that help to ensure sustained investment in asset maintenance. For example, these metrics could provide part of a cost recovery mechanism to enable an efficient company to sustain an appropriate level of asset health if Ofwat does not make ex-ante allowances. The current mechanism of caps and collars would act to protect customers from potential over-investment. The ODI mechanism would ensure that companies, rather than customers, carried the initial risk of the investment. This mechanism is preferable to reverting to "outputs" based regulation as companies would retain the ability to innovate to achieve the asset health enhancements, but would require true long-term investment as it would be focused on asset health, rather than service. For this proposal to support asset health improvements it is essential that the ODIs were balanced with sufficient outperformance opportunity to effect real change for an efficient company.

5. Strengthening incentives

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

Yes, we consider that an initial assessment of plans provides a useful staging post to test whether there are any material gaps between Ofwat and the company views and whether these can be rectified in advance of the draft determinations.

The areas that Ofwat focuses on should be linked to the themes that it sets for the price review, but assessments of expenditure and outcomes are typically the most useful at this point in the process. Other aspects of submissions at PR19 - such as accounting for past delivery - clearly had less of a bearing on the resulting IAP categorisations and so could be addressed at a different stage of the process if this helped to manage workloads.

Q5.2 Should we consider adopting a more light touch approach at PR24 for companies with a strong track record of delivery during the PR19 price review period? If so, what factors should we consider in our assessment and why?

Whilst we understand the apparent procedural benefits it might create, taking a light touch approach to those companies with an apparently strong track record could potentially have unintended damaging consequences. It could reduce the incentive for high performing companies to challenge themselves further, therefore potentially leaving customers with a worse outcome than had Ofwat applied more scrutiny (and intervened). Conversely, it does not give poorer performing companies an incentive to be especially ambitious in their plan, as it might be perceived that it will incur interventions either way given the relatively poor track records. In both instances therefore, it reduces the key incentive to put forward the most ambitious plan possible at the outset of the process. Adopting this type of approach also raises a number of issues:

- It relies upon Ofwat being certain that everything was set at the right levels in the previous price control. As it cannot do this, then it cannot be sure that a company's strong track record is a result solely of strong performance rather than having less challenging or underspecified targets. Attributing successful past performance to the result of company action alone tends to overlook the possibility that past outperformance (or underperformance) of targets is because the targets were mis-specified.
- Information asymmetry means that Ofwat cannot be certain that actual performance is a result of effective management; for example, if expenditure below (or above) the price control allowances is indeed efficiency (inefficiency) or simply reductions (increases) in scope delivered. It would therefore have to take a simplistic approach to assessing cost performance that would remove any incentive for a company to invest additional expenditure for current or future benefits. Instead, it would drive a focus on achieving and delivering short-term benefits and short-term targets.

We therefore do not believe that adopting a light touch approach for companies with an apparently strong track record is in the long-term interest of customers and Ofwat should continue to assess all company plans with equal scrutiny.

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

We do not consider that it would be beneficial to reduce the number of stages in the process. Reducing the number of stages, and hence reducing opportunities to engage with Ofwat on company business plans, risks companies adopting a more combative or even litigious approach to the price control process.

Having three clearly defined stages (an IAP, draft determination and final determination) provides the chance for early feedback/opportunities for improvement and recalibration prior to the more formal determination documents. Having these formal touchpoints in the process is imperative to ensure that companies and Ofwat both have sufficient time and opportunities to address any issues raised in the review of the company's plan.

We can see the value in both options 2 and 3 but having been fast-tracked at PR19, we believe that option 2 is the most pragmatic.

If Ofwat only intends to make (at most) minor adjustments to a fast-track company plan, then an early draft determination alongside the initial assessment of plans (option 3) would be beneficial. It would even out the regulator's workload and give the company procedural benefits.

However, our experience at PR19 was that a fast track plan is subject to far more extensive adjustments and interventions. Assuming that this is again the case at PR24 then Option 3 would reduce the amount of interaction opportunities for a fast-track company has and therefore leave the company in a comparatively worse position, ultimately preferring an approach such as option 2.

If Ofwat's goal is primarily to streamline the process then we suggest instead that it could make better use of company early submissions, providing sufficient notice is given regarding coverage. More dialogue and/or formal gateways for this, rather than simply submitting the information, could help to smooth out the workload more evenly over the period and lead to more informed draft determinations.

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

We do not believe there are compelling reasons why the approaches for England and Wales should be different. Ofwat benchmarks English and Welsh companies consistently and so Ofwat should assess the plans consistently.

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

At PR19, our experience was that fast track plans were subject to more extensive interventions than might have been anticipated given the fast track definition. For PR24 to offer appropriate incentives for companies to once again submit stretching plans in the first instance then we suggest greater acceptance of company plans that have been deemed to be fast-track 'in the round'. This might mean that in some instances, the company receives a more favourable outcome than other companies do in some areas, but this is the benefit to the company for pushing other elements to the frontier and, overall, the plan remains a high quality plan for customers.

We note that Ofwat states that rewards need to be proportionate to customer value created. We agree with this, but we note that the most ambitious company plans are generally used by Ofwat to challenge the rest of the industry, for the (much greater) benefit to all customers, in all future price controls. Therefore, we believe there is the possibility of making the upfront rewards (for individual fast track companies, for an individual price control period) bigger, subject to delivery of certain key objectives selected by Ofwat from the company plan. These would be in the areas where Ofwat felt the plan was particularly impressive and/or ambitious. If those promises in the fast track plan were not delivered, then Ofwat could partially claw back some of the incentive.

We agree that a 'do no harm' principle provides stronger incentives to companies than the 'early certainty' offered at PR19, which effectively invited fast track companies to "gamble" based on perceptions of the likely eventual outcome of the price review for other companies.

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

For UUW, the ability to obtain favourable cost sharing rates at PR19 represented a significant incentive to submit an ambitious and innovative plan. We note the CMA's decision to weaken the strength of the cost sharing incentive for appellants on the basis that overly strong incentives may impede long-term investment decision making.

We propose that Ofwat should:

- Set a basic expectation that cost sharing rates should be held in equilibrium at 50:50
- Reserve the right to apply more punitive incentives to price controls where the IAP assessment is that plans are of particularly low quality, with a possible move to 60:40 rates in customers' favour

Clarity on sharing rates could then be one area where Ofwat made a long-term (multi-AMP) commitment in order to provide additional certainty to companies and investors and promote long-term thinking.

Although it may be desirable to formally embed long-term measures into the calibration of cost sharing rates, it would not be appropriate to use a measure such as asset health status to inform the setting of cost sharing rates. This is not only because no appropriate measures are currently reported, but blurring the lines between cost and outcomes incentives could be counterproductive. Deteriorating asset health over the long-term will lead to more service failures and therefore a worse performance (and resulting ODI penalties). For Ofwat to use such a measure to calibrate cost sharing would in effect be penalising the company twice and reducing the prospects of an early improvement in customer experience.

We do recognise that there continues to be a sound case for the use of specific asymmetric sharing rates for expenditures that are sufficiently outside of management control such as business rates and abstraction licences.

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

We support the inclusion of additional targeted challenges at PR24 as this provides an opportunity to focus efforts on key issues, which have not been sufficiently addressed in previous determinations. Targeted challenges are highly publicised and so help to reaffirm the positive contribution to society and the environment that the sector can have.

We would caution against too many targeted challenges as their impact can be diluted if there are too many objectives to achieve.

We also believe that the targeted challenges selected could be given greater legitimacy by demonstrating that they truly reflect the priorities that customers express - rather than a superimposed view of what customers want - and that they align to wider stakeholder priorities and ambitions for the sector that can be reflected in the respective statutory requirements e.g. the EA and WINEP. This is particularly important because achieving these targeted challenges is not "free". Meeting the challenges requires both the allocation of resources and effort away from other potential priorities and, in the majority of cases, additional new investment that needs to be remunerated.

Ofwat should also not underestimate either the resources or commitment required to deliver targeted challenges in addition to the many other challenges embedded in the price review. At PR19, companies committed to a 15% leakage reduction without additional enhancement expenditure, but this was not a costless improvement; rather, it was an additional productivity challenge that had to be accommodated whilst delivering upper quartile improvements in other service areas. However, this cannot reasonably be considered to be an appropriate template for future proposed challenges:

- Harm caused by discharges from combined sewers has been under the spotlight in recent months. Whilst the public views on this might be strong, storm overflows exist on combined sewers to protect homes and businesses from flooding. Water companies have permits from the Environment Agency to spill to the environment from storm overflows under certain conditions. Whilst the data available on storm overflow performance is on the frequency of operation it is important to note it is a poor measure of CSO performance as it has no relation to either what is required by the permit or the cause of harm. Spill frequency is significantly impacted by the weather so a large part of the variation in performance will also be due to the weather. There is a risk of driving perverse behaviour by focusing on spill frequency where opportunities to pursue reductions in frequency at small overflows are explored and large overflows on big trunk sewer overflows are left untouched. The initial work undertaken by the Storm Overflows task force is likely to highlight that a significant cost implication to reduce the frequency of operation. It would therefore be unreasonable to expect that any change to future spill volumes or impact absent of significant investment from customers, as has been the case in the past. We support the need for further bold action by water companies, and increasingly also by other agents, to further protect and improve the water environment. In defining the best overall approach it is critical that the sector values other important considerations in the air and land environments, and social factors, which are often overlooked in traditional approaches.

- Where targeted challenges are based on absolute levels of performance then there should also be recognition that customers of different companies have paid for different levels of enhanced service in the past, reflecting their specific preferences and priorities. The premise that all companies should be able to achieve the same base level of performance is therefore flawed. To subsequently require that all companies achieve the same levels of performance on common performance commitments for no enhancement expenditure will wrongly create winners and losers as the starting points are, as a matter of fact, not the same.
- The greater the extent of the targeted challenges and the more that the costs of meeting such challenges are not explicitly allowed for, the more questionable the assertion becomes that they mirror the challenges faced by companies in competitive markets – at least in so far as they are assumed to be "cost free". Where a market faces a challenge, the impact on costs for all participants in that market will be reflected in future prices (unless there is directly substitutable good that is unaffected by the challenge). Therefore, it would be incorrect to assume that zero remuneration for any targeted challenges simulates the experience of competitive markets.

The combined impact of unremunerated targeted challenges and upper quartile performance means that companies have to achieve a significantly higher level of productivity improvement than Ofwat claims when it states the additional productivity improvements that it expects the industry to achieve over and above that of the wider economy (c1% per annum at PR19). Companies also have to achieve different levels of productivity to one another based on how much their customers have historically funded for enhanced levels of service.

This presents two issues. Firstly, it undervalues the improvements that companies are delivering for customers when accepting these challenges. Secondly, not fully acknowledging the level of actual productivity required of companies can lead to unrealistic expectations of further potential improvements. Unrealistic assumptions of future improvements might actually then serve to disincentivise focus on the long-term and cause companies to seek to minimise short-term risks – something that Ofwat is actively trying to prevent companies doing elsewhere in the framework.

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

At this early stage, having only recently approved the first wave of projects to be undertaken and given that these will likely only deliver benefits over the longer term, it would seem appropriate for Ofwat to assume that the PR19 innovation fund process would continue into PR24. A review of its efficacy should then be undertaken in advance of any further price control processes.

We do not believe that Ofwat needs to commit to an approach one way or another at this moment, nor do companies need to include it within their plans – both the innovation fund and water transfer projects were added relatively late during the PR19 process but were successfully incorporated into final determinations.

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

We support the promotion of EBR through PR24 as it very much aligns with our approach to responsible business where we have a good track record of operating in an ethical and responsible manner. It is one of our key strategic themes and we regularly use ESG ratings and indices to benchmark our responsible business performance as these provide external and independent assessment of our progress. Information on how we manage the business to deliver value to our stakeholders is published in our integrated annual report and accounts, including how executive and employee remuneration links to customer and environmental outcomes.

As well as actions that companies should undertake, embedding EBR requires the right framework to be set by regulators. We should accept that there might be less certainty of output as we embrace EBR so investment rules need to accommodate this. This is illustrated by the adoption of nature based solutions where securing the outcome can take longer than traditional hard engineered solutions and the delivery route can sometimes be less obvious (partnership rather than construction supplier) but there is wider value to the environment and society from this approach. It should not be presumed this uncertainty is inherently inefficient. Such solutions require us to think beyond the current regulatory price control period to aid assessing outcomes. We highlight this problem further within our response to Q10.4

While it is sensible to avoid any attempt to prescribe EBR and to set specific measures, there are frameworks that align well with its intentions. Already, we adhere to the Corporate Governance Code requirements for listed companies. In addition, we would encourage companies to enhance their disclosure of value generation through reporting, for example by adoption of integrated reporting principles[2]. This encourages companies to consider and report their impact through the lens of six capitals (manufactured, financial, natural, social, human and intellectual).

[2] https://integratedreporting.org/

6. Reflecting customers' preferences

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

We recognise the desire for a more co-ordinated and collaborative approach to researching areas of common concern across companies' regions in relation to common performance commitments and incentive rates. We recognise that past variances in research results between different regions are difficult to explain when they do not adopt a common approach.

For a collaborative approach to standardised or nationwide customer research to work well, there should be early identification of aims, outputs, roles and responsibilities. Ofwat will need to ensure that the sample size is large enough so that it is capable of reflecting the views of all types of customer, including those that are hard to reach and that the research is conducted objectively as not to skew the results. In order to allow company business plans to be informed by the research, it is essential that it is delivered well in advance of companies drawing up plans. In this context we note that early business plan submissions are already due in less than two years' time.

We are supportive of a more collaborative approach in researching customer's views on affordability and acceptability of business plan proposals; however, we believe strongly that a fully centralised national research project in this area should not be attempted prior to business plan proposals being submitted to Ofwat. Completing such research whilst business plans are still being developed is a hugely complex task, which requires flexibility around timelines to execute effectively. A national approach could not offer flexibility around timelines, and is therefore likely to generate results that do not accurately reflect many companies' final business plan proposals. Instead, we believe that companies should continue to conduct their own research into the affordability and acceptability of business plan proposals prior to business plan submissions, but that we could collaboratively generate clearer guidance on the design of such research.

It is crucial that stakeholders have a full and active role in developing research to maximise the level of engagement and support for research techniques and outputs. Independent oversight also has a key role to play here. Ofwat's proposals provide a good foundation to build upon in this area. Clear governance and timelines for delivery should be established as soon as possible to enable companies to build business plan development programmes that incorporate the outcomes of national research. All companies need an opportunity to engage with development of research design and execution. We believe standardised guidance, rather than fully centralised research has an important role to play in a wide range of areas of research, particularly where companies face local challenges, or where companies propose innovative approaches to addressing common problems.

We agree that national research should be robust and representative of local populations' views. This means that sample sizes at a local company level need to be adequate to ensure the views of key customer groups can be reliable captured. Ensuring the views of vulnerable customers, low income groups, future bill payers and SMEs is likely to be particularly important. In line with Ofwat's statements on ensuring that research is relevant and understandable by customers we believe that a national research programme should be focussed on customer priories and valuations of the services they receive, and not become drawn into regulatory principles or policy/methodology choices

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

We welcome that Ofwat is considering the best way to implement a collaborative approach as a centralised approach to generating customer insight without broader input may struggle to command company confidence or could be delivered too late in the price review process to influence business plan development. Clear governance structures and concrete programme milestones are a first step in mitigating this risk. We encourage

Ofwat to work with companies and stakeholders to rapidly put in place governance groups and a clear timeline for delivery.

We support proposals to put in place a central body of independent experts to challenge and assure collaborative research efforts. Research that stands up to independent scrutiny is important to ensure all stakeholders, including company boards, regulators and customers can have confidence results are reflective of regional customer views. Ofwat should also give proper consideration to locally sourced evidence from companies about customers needs, wants and preferences. Many of these research exercises are high quality and reveal compelling insight about the regional customer base, including customers who might otherwise be difficult to reach and engage with generalist research techniques. This evidence should not be discounted merely on the basis that it was not part of the nationwide or standardised approach.

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

We do not believe that negotiated settlement is an appropriate basis for the water and wastewater price reviews overall. However, in our previous representations, we raised the prospect of localised negotiated settlements, focussed on smaller sub areas of the overall price review. We continue to believe that negotiated settlements could be a useful addition to the PR24 framework if efforts are appropriately targeted at specific areas where customers are best placed to make an informed contribution. However, it would be difficult to advance this approach without wide ranging support from companies, Ofwat and other key regulators from the outset. Negotiated settlements bring the advantage of enabling a wide range of stakeholder views to be aired and considered, and consequentially lending legitimacy to the final settlement. Questions related to the scale, scope and pace of discretionary service enhancement, and associated efficient investment would appear to lend themselves better to a negotiated settlement approach. Equally, it is not intuitively clear that a negotiated settlement approach would generate a 'better' answer than traditional central regulation in more technical areas such as relative efficiency, legislative drivers or risk/reward balance.

Under the existing PR24 framework proposal, it would be difficult to undertake enhanced immersive customer engagement, with for example a citizen's assembly. The citizen's assembly would need to consider evidence presented by a wide range of stakeholders, including from the company and regulators, on predefined discretionary service choices, and provide a final view on their view of the preferred scope, scale and pace of service improvement and investment/bill impact to Ofwat. Without a robust framework underpinning stakeholder engagement in the process it would be difficult to robustly demonstrate that all aspects of an issue are adequately considered. This view would not be formally binding on Ofwat, but a well conducted negotiated settlement could provide compelling evidence on the breadth of customer views.

Given that a negotiated settlement approach – even for limited and specific topics within the price review - would require wide ranging support from companies, Ofwat and other key regulators from the outset, it is unlikely to occur organically without early support being given to the approach and identified areas of focus. However, if there was support for adopting such an approach in discrete areas of the price review, and this was signalled sufficiently early, then United Utilities would be willing to engage constructively and use such an approach in developing its PR24 business plan.

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

We are supportive of the approach outlined. We agree that Ofwat is well placed to provide clear guidance on the expected assurance companies should provide on customer engagement. Greater clarity in this area is welcome as it improves the likelihood that future research can influence both our business planning process and regulators views of appropriate determinations.

The YourVoice CCG in the North West, has repeatedly demonstrated that it is a robust and independent body that effectively challenged and assured UUW's customer engagement programme at PR19. In the past, the views of YourVoice have formed an important part of the United Utilities Board assurance process, both in relation to Price

Reviews and wider reporting. We however do understand concerns that perhaps not all company CCGs may have achieved the same high standards of independence and capability as YourVoice and so agree that companies should have more scope to develop a better route for putting in place assurance processes for their circumstances.

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

Further guidance and standards would be welcome, including on customer challenge and engagement. However, to have the most impact on business plans, the guidance needs to be provided as soon as possible as companies are already in the process of developing their business plan approach. We recognise national collaborative research efforts will provide important insight into customers on common performance commitments and incentive rates. There are however, a wide range of other, more localised issues, that merit capturing customers views on.

As part of PR24 business plan development, we are again conducting a range of customer research projects. Clearer guidance on research standards will enable us to more easily demonstrate the robustness of our research programme, and enable regulators to have increased confidence that the results of our research is truly reflective of customer views.

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

United Utilities has limited involvement in the regulatory framework applying to Wales and our comments in this response relate to the regulatory framework applied in England.

7. Planning together for PR24

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

Companies will develop their PR24 business plans drawing on the outputs from the strategic planning frameworks that help shape their future investment requirements. For the most part, basing the business plan on long-term strategic planning is not new. What is new is that the development of new frameworks such as the DWMP will increase the standardisation of the approach that companies take to assessing the long-term factors that they need to account for, increasing the comparability between companies in how their plans are presented. This should be a positive development from a price review perspective.

Because of the different timelines on which the various frameworks all finalise, one of the key challenges we face in PR24 is that a much greater proportion of future requirements might be uncertain at the time companies submit their business plans. When coupled with companies seeking to deliver greater value in addition to the narrow definition of their statutory obligations (e.g. through delivery of greater public value and nature based solutions) future requirements and benefits can become even less certain. Increased uncertainty is obviously undesirable in a process that currently focuses on making ex-ante allowances.

It should be possible to design the price review so that it successfully mitigates this issue. Ofwat's introduction of the WINEP uncertainty mechanism in PR19 was a good example of trying to address some of the uncertainties that are present when setting a price control, protecting both customer and companies from future changes. Ofwat should look to what other areas that it could reasonably provide the same sort of protection. It might be that a greater focus on ex-post rationalisation rather than trying to provide ex-ante certainty would provide the most coherent and effective way for business plans to be developed; reducing the time spent on trying to evidence (and review) something that is inherently unknowable, to instead focus on what is known.

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

We welcome Ofwat's recognition that its assessment and challenge of companies' plans is most effective when it is joined up with other regulators and CCW. We agree that the onus is on companies to develop their plans with suitable challenge and engagement with the other regulators. Where there are areas of disagreement between Ofwat and the company, particularly on the need for an investment, Ofwat should actively engage with the other regulator(s). Strategic planning frameworks are complex and interventions are often interdependent and so assessing the validity of an intervention in isolation is not always appropriate. As the other regulators should have better insight and knowledge into the wider plans, it makes sense that Ofwat should seek their views before deciding upon an outcome. For transparency, Ofwat should consider the extent to which this engagement can be made public so that all stakeholders have a record of the decision and the reasoning behind it. This will prevent situations occurring where there is a mismatch of understanding about the relationship between delivery of statutory obligations and their remuneration within the price control.

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

We think that a 'Challenge Panel' would best be engaged prior to business plan submissions. It could be specifically engaged in thinking about the criteria that Ofwat might apply to its business plan tests. Given the difficulties that Ofwat itself has in reviewing and absorbing the business plans in a limited period before draft determination, it seems unlikely to us that a panel of experts is likely to be able to make reasoned judgements on company plans during the same period.

We also recommend that Ofwat not only seeks to include other regulators and customer representatives on this panel but also ensures it reflects the views of the investor community. Investors are a key stakeholder in the price review process and this will help to ensure that the panel advances proposals in relation to business plan assessments taking into account the broader (but essential) perspective that investor and industry stakeholders can provide.

8. Design and implementation of price controls

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

We agree that it is appropriate for PR24 to retain the same broad structure of price controls as at PR19. This includes delivering on prior regulatory commitments to the protection of the historic investment made and reflected in the RCV.

We support the principle that Ofwat should make further improvement to price controls where this is clearly necessary or will clearly result in outcomes which best serve the long-term interests of customers. However, we would advise caution when looking to make further changes at PR24 without taking time to understand the need for change and the current barriers to competition. Stability and predictability within the regulatory framework is a key principle highlighted by the Department for Business, Innovation and Skills (BIS) to enable “all those affected to anticipate the context for future decisions and to make long-term investment decisions with confidence.” With this in mind, care should be taken not to make substantial changes without first fully understanding the need (and cause) and secondly, to communicate future strategy and pace alongside the proposed changes.

Without this, our view is that the effectiveness of regulatory incentives will be reduced, no matter how well designed. The sector is characterised by long-lived assets and investment plans and so it is right to expect that change will often be evolutionary rather than sudden. We would therefore encourage Ofwat to only make considered changes and to provide further clarity on the future strategy and ambition wherever it feels the need to improve the implementation of the price control. To this extent, in the same way that Ofwat is seeking for companies to set out their business plans as part of their long-term ambition, we would encourage Ofwat to similarly set out its long-term objectives and how (and how quickly) it plans to transition to this outcome. This will give all stakeholders, including incumbents, the right information on which to base future decision-making enabling them to respond to the incentives appropriately.

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

8.2.1 Water resources

The proposals for potential price control boundary change risks confusion with the contestable boundary for new water resources. Given Ofwat is not seeking views on extending the activities that it expects to be subject to competition, we assume that this is not changing, despite the proposed change in the price control boundary. In our view, such a change to the contestable boundary would be a significant shift in the way the industry and its quality regulators operates and is not something that would automatically drive increased activity and/or competition. Any such proposals will need to be subject to specific consideration and consultation. It would therefore be helpful for Ofwat to clarify its expectations for how its proposed price control interacts with the market for new water resources. We do not consider that there is an immediate or justified need to change the boundary definition within Water Resources to include other value chains in order to promote more activity within the market.

Firstly, unlike (business) retail activities where competition has previously been introduced, Water Resources is an asset intensive part of the value chain with large setup costs. Changes are therefore likely to be gradual and take time to develop. Companies have already sunk significant costs into developing these parts of the value chain, but only to meet the needs of customers within their own regions and managed through their WRMPs (hence constructing additional capacity prior to competition would have been inefficient). For another party to capable of replacing that activity immediately is an unrealistic assumption. Therefore, the development of competition in these areas will likely take some significant time, with the market being most active only when new capacity is needed, rather than from conception to replace existing capacity. The work of RAPID and regional Water Resource groups is already helping to stimulate this activity, but it will take time and iterations of company WRMPs.

Secondly, in seeking to try to encourage trades between parties, Ofwat should be mindful that current incentives are geared towards reducing the demand side (PCC, leakage etc) rather than increasing supply. This will invariably lead to less of a focus on developing new resources either traditionally or through trades (as the supply demand balance improves). It is therefore not unexpected that companies have had less focus on the upstream business and more on the downstream as that is exactly where Ofwat and Government has focussed company attention in setting PR19.

Finally, Ofwat cites that one of the benefits of disaggregation is that it can then set specific cost efficiency targets for the different price controls. We would remind Ofwat that setting disaggregated efficiency targets creates an unachievable benchmark across the aggregated services due to (a) the substitution effects that are present across the value chains and (b) unmodelled factors that influence each companies' costs for a service "in the round". Ofwat notes these substitution effects in discussing reasons for adjusting the boundary and this should not be ignored when considering how to set appropriate allowances. Inconsistent reporting of cost, as Ofwat highlights, further exacerbates this problem.

8.2.2 Developer services

We believe that Ofwat should follow a cautious approach to proposals in this area. There are many issues and barriers to be overcome in moving towards the form of price control that Ofwat is proposing, for example:

- There is not a common approach to the boundary between contestable and non-contestable services across the industry. It would seem clear to us that this would need to be tackled before changing the form of price control.
- Similarly, some activities are partially contestable and part non-contestable. These activities, and their associated charges, would need to be separated prior to changing the form of price control.
- The income offset could not form part of a contestable price control. Whilst we note Ofwat's recent consultation, aimed at discontinuing the use of the income offset, we responded to that consultation to clarify that it would be too big a change to remove the income offset fully by the start of AMP8, and that it would need to be transitioned out during AMP8, with recognition of that transition within the PR24 price control. Whilst there may be options to that could be applied (e.g. the income offset alone could continue to form part of the single till wholesale price control), it would seem preferable to defer any such changes to AMP9.

8.2.3 Bioresources

In general, Ofwat has provided a positive and well considered view on the constraints and opportunities for future market engagement in Bioresources. This includes proposals for greater levels of collaboration and the creation of a bidding framework to encourage third party engagement in the provision of Bioresources treatment. We welcome this.

The impact of uncertainty relating to changes in environmental regulation on inhibiting the furthering of the Bioresources market is highlighted, but not directly addressed. Ofwat will need to lower the expected outcomes of this market if these uncertainties remain.

The preferred approach to cost assessment has a number of issues that need to be explored further. Whilst it may be feasible at some point in the future, it seems unlikely to be a suitable approach for PR24:

- The approach has the potential to strand assets without providing clarity on how Ofwat will maintain its prior commitments to protect the pre-2020 RCV. The commitment to RCV protection should be maintained in order to avoid undermining investor confidence in the sector.

- The proposed approach includes the potential for Bioresources costs to be compared, and assessed, against the price of treating Other Organic Waste (OOW), or sludge trades. We do not believe that would be an appropriate, or fair comparison.
    - The price provided for OOW is for a different service and therefore is not comparable. Trade prices are set dependent on the particular circumstances of the site importing the sludge, with particular restrictions and caveats.
    - Most sludge trades do not provide a guaranteed service and therefore do not remove the need for resilience to be covered off by the exporter. To be comparable to Bioresources costs, the price offered must reflect guaranteed availability of capacity to take the supply. Also, the pricing of short term trades, allows (per RAG5) for only a portion of average costs to be recovered. Therefore, this too would not be an appropriate comparison to the full costs of providing a Bioresources service.

In summary, trades (and their prices) do not adequately reflect the cost of incumbent's pre-existing service obligations for managing regional Bioresources services, and would therefore be unsuitable to assessing the efficient costs of each company meetings its obligations.

8.2.4 Residential retail

In reviewing the consultation comments on residential retail, it is not immediately clear to us what Ofwat is proposing. The consultation notes that the PR19 approach to average revenues remains broadly appropriate but that it might instead seek to target allowed revenue, consistent with the other controls. This would then imply that the proposal is a total revenue control – representing a significant change to the structure of the control and not consistent with Ofwat's initial statement. We would welcome further clarity on Ofwat's proposal so that we can make a more informed response.

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

We support the continued exploration and development of DPC as an option for delivering the best value outcome for customers. We note, of course, that DPC has yet to be successfully implemented for any project identified at PR19 and, accordingly, there remain a number of issues to resolve before we believe more widespread adoption should be advocated. In our experience, we see the biggest barrier to pursuing a direct procurement as being unfamiliarity with the approach and the untested nature of the framework. Current schemes being developed through the DPC framework are testing the possibilities, not just for the companies and customers involved but also for potential future investors. Their success or failure will help to provide guidance on how a DPC process can be made to work better in future.

The best way to reduce the administrative burden and bidding and procurement costs of DPC is by learning and sharing experience and demonstrating alternatives. We think this is more likely to deliver the best processes to support DPC rather than boilerplate approaches which may not be sufficiently supportive of the specific project being tendered, especially when DPC remains largely unproven.

We see that there is potential for associate companies to invest in DPC proposals but struggle to see how companies could "back" one bid before award and then run a tender process on a basis that is seen as fair and equitable. We believe that companies must, however, run the tender process if it is ultimately going to be providing service to the appointee. One possible solution to this would be to allow associates to co-invest in DPC delivery following contract award, on commercially agreed terms.

We have no objection to Ofwat trying to develop a longer term view of future investment projects. With strategic planning frameworks moving to looking longer term, this might drive out a better view of future requirements that have the potential to be delivered through DPC. Ofwat should consider whether it wants to go for a "database" type approach to cataloguing future projects or whether, instead, it wants a long-term forward looking submission document as a more descriptive part of the PR24 process.

In either case, we note that providing such a long-term view will:

- take time and resources to set up and so it is important that objectives and requirements are set as soon as possible;
- need to deal with confidentiality issues re: asset condition and criticality; and,
- need to be delivered on the basis that there are highly likely to be changes and revisions from time to time based on changing factors and developing views; the list of projects in the pipeline are unlikely to be entirely "fixed" into the future. Appointees need and value the scope to review and change proposed outputs and the pipeline of projects over time in order to deliver the best overall outcome.

Ofwat notes in its consultation that it is considering future use of licences under the Special Infrastructure Projects regime. We see this as a legislative issue and an area for government policy direction (as opposed to a matter for price review policy.) Special infrastructure projects are defined by specific criteria in legislation, which are generally not applicable to projects being considered by companies as part of the price review.

9. Outcomes

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

Performance commitments have led to a step change in performance for the industry, whilst giving customers simple and transparent understanding of company performance. In particular, they have provided the greatest single source of regulatory support for innovation in the sector, as solutions to issues no longer need to be tied to delivery of pre-agreed inputs/outputs. However, we consider there is further work to simplify performance commitments and improve the levels of consistency in methodologies and approaches companies use. Expanding the number of common performance commitments to include bespoke measures that have been commonly adopted by companies in the current period (e.g. blockages) would further help enhance the strength of these incentives.

Performance commitments should align to priorities driven by customers and their wants/needs. Priorities may vary by the different areas companies serve, and even within company areas, therefore robust and transparent customer research is essential to support future performance commitments. Bespoke performance commitments are therefore likely to still be needed to ensure each company's business plan delivers for local needs. Whilst we are sympathetic to Ofwat's proposal to reduce the number of bespoke outcomes, and ensure they are set within a long-term framework, bespoke performance commitments should continue to play an important part in making price review determinations relevant to the communities they serve.

Bespoke outcomes are both helpful and necessary to reflect real differences between company regions, and the different views of customers within those regions. They have also been very successful in supporting delivery of improved services to customers, that would not have been captured by the common measures, and it is important that Ofwat continues to support them, where appropriate. The following examples from UUW's suite of PR19 bespoke measures help to demonstrate the benefits from bespoke measures, which Ofwat should be cautious against losing:

- Monitoring performance against company specific risks (e.g. keeping reservoirs resilient);
- Measuring impacts on customer/community experience of services received (e.g. measuring complaints due to taste, smell and appearance, reducing areas of low water pressure, and lifting customers out of water poverty)
- Incentivising positive supporting activities, and delivering better value (e.g. supporting customers with water efficiency advice, achieving BSI accreditation for priority Services, and enhancing natural capital value for customers)
- Supporting related contestable areas (e.g. non-household voids and gap sites incentives)

Performance commitments have improved service levels in many areas within the 5-year price control periods. Future performance commitments should maintain the emphasis on improving service whilst also including a focus on long-term needs, such as addressing climate change risks and maintaining assets resilient to climate change. Clarity on longer-term service level expectations would add value only if similar clarity on associated enhancement cost allowances and incentive rates was also provided.

Some areas of company activity are faster changing than others. The wider environment in areas such as household retail and developer services do not lend themselves to very long-term targets.

To ensure transparent company comparisons that drive real improvements for customers common performance commitments require robust methodologies for all companies to adhere to in a consistent way.

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

We are broadly supportive of price control deliverables (PCDs) as a means of remunerating and monitoring the delivery of specific outputs not directly linked to an outcome. Given the likelihood of there being increased uncertainty in some aspects of PR24 requirements (see our response to Q7.1), PCDs could offer a more structured and common solution to this problem, rather than companies proposing bespoke cost-recovery performance commitments.

We see PCDs operating in a similar way to how some of Ofwat's PR19 reconciliation mechanisms work (e.g. the WINEP uncertainty mechanism and the DRSA) although we would expect to see them be designed to facilitate revenue recovery as well as recognise costs incurred during the AMP.

If Ofwat is going to use PCDs more to address underlying ex-ante uncertainty in the programme, then it should be clear on how reconciliations are to occur before companies submit their plans and not develop this afterwards. Whilst mechanisms such as this are useful, they can create cashflow problems for companies if interventions do not receive in-period cashflows. Increased usage of such mechanisms might therefore be impractical unless Ofwat makes an initial allowance, with mechanisms used to correct variations in requirements (as was the case for WINEP). Furthermore, we expect that the PCD additions would be result in adjustments the RCV rather than revenues, and there is (currently) no option to adjust in period revenues to account for them.

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

We agree that it might be more practical to take non-financial measures of company performance outside of the price review process. This could enable more regular and targeted reviews of how ambitious companies are being in some of the non-service related aspects of how they are operating. Ofwat can then use this to call out best practice whilst perhaps setting industry targets and thresholds.

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

We support Ofwat in setting stretching but reasonable performance and for the reasons that we highlight in our response to Q5.7, we would caution against the assumption that improvements in service are delivered through base cost – these are by definition an enhancement investment (formally referred to as enhanced level of service) and therefore a productivity improvement is required. Ofwat's aim therefore, should be to set a stretching and reasonable expectation of what can be delivered through productivity improvements only and not assume that all companies can deliver the same underlying performance (and improvements) regardless of historic investment levels.

If Ofwat is expecting companies to reflect (or respond) to the baseline that it derives in advance of business plan submissions, it must be transparent and issued in sufficient time that companies can fully reflect upon and properly respond to the information. Providing this information too late in the development of company plans will result in companies being unable to meaningfully incorporate them into their plans.

It would also be helpful for Ofwat to set out how the provision of baselines in advance of submissions might interact with (2-sided) cost adjustments and whether there would be an expectation that they are accounted for in advance or something that is adjusted *ex post*. We would note that a perverse incentive would be created by enabling cost adjustments for differences in service levels – companies that had historically spent more would continue to get more, even if it is not efficient. Should 2-sided adjustments come later in the process then companies would likely need to reflect the revised allowances (either higher or lower) in their forecast performance making the initial reflection/response invalid.

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

We do not agree that it is appropriate for Ofwat to make incentive payments contingent on overall industry targets being reached, all companies improving to at least a certain base level, or evidence that stakeholders also contribute to achieve outcomes alongside companies. Companies can only be held responsible for their own actions and decisions and so to make incentives contingent on others increases the unmanageable risk that a company faces.

10. Cost assessment

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

As we state within our Future Ideas Lab publication 'The Principles of Regulatory Cost Assessment', given the complexity of modern utilities the first goal of cost assessment should be to define the services provided by the value chain in question. Service definition establishes:

(i) The interdependencies between different parts of the water and wastewater value chain; and

(ii) The different cost drivers of services delivered in parallel within the same value chain.

While Ofwat addressed point (i) by considering the interdependencies between services e.g. water resources and treatment with the 'water resources plus' model split, we do not feel that it sufficiently addressed point (ii), in particular by assuming the foul drainage service and the same cost drivers could explain surface water drainage service. We consider that this hampered its ability to assess efficient costs at PR19. At PR24, we consider that Ofwat could improve its approach by defining the services provided within each element of the value chain and designing its approach around this definition. Ofwat might also consider utilising a more diverse suite of models, accounting for a wider variety of cost drivers. Whilst the PR19 model suite did have diversity within the dependent variable (cost) through different aggregations, there was limited diversity within the independent variables to account for different cost pressures.

Ofwat's PR19 approach was characterised by a parsimonious 'sensibly simple' model suite. We consider this to be a legitimate methodological choice, and note that Ofwat's models represented a substantial improvement to those used at PR14. However, while a parsimonious modelling approach is able to derive a baseline that is appropriate at an industry level, it may create distortions at a company level as there are less differentiating factors assessed. This means companies should be expected to submit more cost adjustment claims as a result, and therefore Ofwat's approach should be more accommodating of that need. In light of this, we consider that the evidential bar applied to cost adjustment claims at PR19 was too stringent. Ofwat may wish to revisit its approach in this area. Making the evidential requirements clearer up front would help facilitate discussions that are more constructive and result in a higher quality submission from companies. We noted instances where we satisfied Ofwat's concerns in one submission, but Ofwat's subsequent response raised new, previously uncommunicated concerns.

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

We consider that Ofwat should look holistically at its frontier shift efficiency challenge, which reflects the net effect of productivity improvements and real price effects. While this benchmark received widespread attention during PR19 and at the CMA appeals, its relationship to an 'implicit' frontier shift challenge received only limited scrutiny. In particular, we were surprised that there was so limited recognition of the relationship between the overall efficiency challenge alongside the challenge to achieve 15% leakage reductions for no additional expenditure. It should be recognised that this is by definition an enhancement activity whereby the cost of delivery would need to be met from additional future efficiency, on top of base productivity gains. Without explicitly recognising this relationship as part of its productivity benchmark, there is a risk that:

- Understating the true productivity improvements being made or targeted by customers tends to reduce the sector's credibility among stakeholders and undervalue the extent of stretch being delivered in its performance Future, additional expectations of performance improvements may be unrealistic because the degree of stretch required to deliver them has been underestimated.

We note the choice of more detailed benchmarks being pursued by Ofwat, through the collection of more detailed data but only for leakage and metering within the Annual Performance Report (APR), and proposals to collect more detailed 'P removal' information in next year's APR. While we support the collection of more detailed information in these areas, we query why Ofwat does not also wish to get better data about sewer flooding and wider drainage resilience activities. Drainage-related issues are a significant concern, raised by many companies and stakeholders before, during and since the PR19 and the CMA appeals process, and are likely to become more prescient in future price reviews due to increasing pressure from climate change and demographic factors. More granular data on drainage requirements and sewer flooding performance will allow Ofwat to properly understand and engage with the problems faced by companies operating in areas of intense rainfall, and how the specific challenges these companies face are systematically different from companies in areas of low rainfall, just as the specific challenges that companies in water stressed areas are given clear and distinctive consideration.

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

It will be important for the cost assessment framework to acknowledge that companies may take different approaches to achieving net zero because of their individual operating environments. There is also considerable uncertainty over how much achieving net zero will cost, over both the short and long-term. It is clear there are many financial, environmental and social co-benefits to be better explored and secured from a bold focus on carbon. Given these concerns and opportunities, we consider the best way that Ofwat can help facilitate these ambitions is to have a clear and transparent approach to valuing carbon and assessing the 'net zero' element of companies' business plans. Encumbent with this is the need to ensure that companies are effectively supported and not disincentivised from innovating in their pursuit of the multiple benefits in achieving net zero.

Ofwat should also be cognisant that its future benchmarks could be affected by the differing approaches to net zero taken across the industry if it chooses to use forecast data to develop models. Given that benchmarking relies on the comparability of companies, if not fully understood, this problem could limit the effectiveness of traditional means of benchmarking companies' business plans. Compounding this problem is the notion of 'best value', an idea that might become more prominent as companies increasingly pursue the multiple benefits of both net zero and public value in their plans. Different companies will have different definitions of 'best value', for example, if companies undertake optioneering using a natural capital or a multi-capitals approach. This will mean the incremental difference between 'least cost' and 'best value' might vary across the industry. The different approaches might cause difficulties for Ofwat when trying to understand whether the difference between 'least cost' and 'best value' is efficient and in customers' interests.

Finally, Ofwat should recognise that historical benchmarks may not be reflective of 'best value' projects in future periods.

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

As we stated in our presentation to Ofwat's Cost Assessment Working Group (CAWG) on 26 May 2021, the current framework could disincentivise the proposal of nature based solutions, even when these solutions are cheaper, preferred by and/or deliver better value to customers and the environment. This is due to the presence of three biases in the PR19 approach:

- Bias in benchmarking models - models have utilised explanatory variables associated with capital solutions (outputs), because that is what the available data has allowed, and that was how the WINEP was specified.
- Bias in remuneration - cost assessment recognises expenditure needs in the same AMP as the enhancement is first required, but does not recognise expenditure needed for ongoing management of a nature based solution over multiple AMPs.
- Bias towards *ex ante* certainty – traditional capital solutions often represent the 'tried and tested' and therefore offer a greater level of certainty over the outcome and the benefits that will be delivered.

Important if cost assessment is concerned with ex-ante allowances and the quality of supporting evidence for atypical cases.

Ofwat's approach at PR24 should create the right incentives for companies to reveal potential catchment and nature based solutions upfront in their business plans. In particular, Ofwat should not expect or require companies to be able to provide equal certainty on costs and outcome targets as for traditional solutions – to do so will act to disincentivise companies from proposing innovation through nature based solutions or strongly embracing them as core drivers of their plan.

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

As we stated in our response to Q10.2, we support the collection of more detailed information on leakage, metering and P removal. However, we do not understand why Ofwat is not also seeking to increase its understanding of the relationship between costs and service in other areas, specifically in relation to sewer flooding, by asking for more comparative data in this area.

Additionally, it would be useful for Ofwat to recognise that companies performing at the 'upper quartile' have received funding:

- Before the company was an upper quartile performer; and
- After the improvement in performance, due to performance-related reward payments.

These companies have effectively benefitted from double payments related to their upper quartile performance. However, other companies have not benefited from similar funding but are still expected to achieve the same levels of performance. This effect would be worth understanding in more detail, because it directly affects the level of stretch created within a company's final determination. This also links to our concerns relating to productivity benchmarks set out in our response to Q10.2.

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

It is not clear to us why additional mechanisms beyond the Performance Commitment and Outcome Delivery Incentive (ODI) regime are needed. Properly calibrated ODIs should provide sufficient incentive and reward for an efficient company to improve its performance. Any additional mechanisms would add complexity to the regulatory framework, which in our view would be unnecessary, given the incentives already provided by ODIs.

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

Botex benchmarking models are a backward looking assessment method that reflect what companies have delivered in the past. As we set out in our Future Ideas Lab publication 'The Principles of Regulatory Cost Assessment', cost assessment also needs to reflect future pressures; it is not appropriate to assume that historic expenditure is representative of future requirements.

To address this concern, Ofwat could introduce supplementary forward looking, risk-based assessment methods and triangulate its backwards looking botex benchmark with these. This will provide stakeholders with more confidence that genuine investment needs will be acknowledged, and provide companies with confidence to highlight future resilience issues without fear of being placed in slow track or significant scrutiny.

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

We consider that the Water Resource Management Plan (WRMP) and Drainage & Wastewater Management Plan (DWMP) processes ensure that companies are appropriately considering the effects of climate change and population growth in these areas of activity. We note that interventions to address these pressures should be classed as enhancement activity.

However, asset health is not directly captured by these processes, rather it is typically used as an input and therefore consistency in future projects across the industry will be mixed. Unlike external drivers such as climate change and population growth, interventions to address underlying asset health issues are typically base/maintenance activities. This risks the issue of asset health being overlooked and underfunded, which could store up significant problems for future customers.

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

As set out in Q4.7, we consider that outcome incentives should be paid as close to the period they are earned to maintain strong incentive properties, rather than deferring to future periods based on achieving prolonged performance.

We also observed that during the CMA appeals, the CMA noted that swings in cost sharing rates across AMPs could create a disincentive to properly invest in the current period in projects with a payoff that stretches across multiple AMPs. This is because the company would pay for the project in the current AMP but could not be sure it would receive sufficient benefits to make the investment worthwhile, due to a possible change in cost sharing rates in future AMPs. We share the CMA's concern, and consider a 50:50 sharing rate to be optimal. Ofwat could instead strengthen the incentive effect of the WACC to create efficiency incentives for companies.

11. Risk and return

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

We agree that Ofwat should not pursue simplicity as an end in itself when adjusting the regulatory framework. The complexities present within the current framework are reflective of the intricate differences between both how companies operate, combined with the need for precision in the answer when setting the determination to prevent winners and losers. The need to be able to derive a more precise answer necessitates more complex frameworks, more assumptions and so ultimately, more reconciliations. Therefore, whilst it does increase the regulatory burden, the need for a more precise prediction ultimately reduces the risk exposure for both customers and companies. The contrary would result in a less precise answer, which would ultimately risk winners and losers and therefore increase the exposure for customers and companies. We do not think that there are key areas of the price control framework that would benefit from having less precision.

We would caution against an over-simplification of the outcomes regime that resulted in too few bespoke ODIs. Whilst we accept the need to reduce the overall number of performance commitments, there is a clear need for bespoke ODIs to help differentiate between companies operating environments and importantly, the different preferences of their respective customers.

Like many in the sector at PR19, UUW was uncomfortable with Ofwat's assertion that the efficient company was being benchmarked as the third or fourth placed company in respect of cost efficiency but also simultaneously the upper quartile across Performance Commitments and ODIs. This has not been borne out across the sector where even the highest performing companies typically lead on some measures but do not achieve sector-leading performance across all metrics.

Ofwat will have a wealth of data from AMP7 and previous AMPs from across the sector to better establish a more realistic 'benchmark' assessment for the efficient notional company in respect of totex and service performance, and set a stretching but more realistic 'glidepath' to upper quartile.

Whilst it is still relatively early days in respect of AMP7 performance, we would welcome a review of the best use of caps and collars for customers in setting ODI's for PR24, as it seems incongruous that a company can make outsized rewards on one metric for performance that does not look particularly stretching when benchmarked across the sector.

Ofwat should reflect on evidence of the 'trade-offs' employed by companies across AMPs 6 and 7 in order to test any assertion that spending less is good and spending more is bad, particularly with a focus on long-term resilience. A broad based 'ex post' assessment of Price Review regulatory settlements versus actual outturn across the sector would be useful to inform recognition of such 'trade-offs'.

We would note that HMT has just published a consultative document (responses due by end of August) advocating a move to a system more akin to self-assessment for Business Rates rather than its current approach. This might necessitate a similar change in Ofwat's approach to Business Rates.

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

UU supports greater consistency in Ofwat's risk assessment of companies' business plans, and it should be possible with the data collected through AMP7 and previous AMPs for Ofwat to determine correlation between risks and set appropriate coefficients etc.

We believe that in assessing risk, companies pension scheme deficits are currently a 'hidden' risk and could be a threat to long-term financial resilience. Ofwat drew a line under customer bills supporting pension deficit recovery payments at PR09 and for most companies the final allowance for such payments will have ceased by the end of AMP7. However, the sector still has material pension deficits and UU believes that such deficits (on a statutory financial reporting basis) should be taken into account both with regard to recognition of the impact of such deficits on a company's net debt and gearing position (consistent with the credit ratings agencies) but also in any RoRE analysis (see also our response to Q11.7 in respect of financial resilience).

At PR19, UU incorporated correlation into the risk assessment of its business plan submissions with consequently a narrower RoRE range as the outcome. This, coupled with a large RCV meant that UU struggled to calibrate a RoRE range consistent with Ofwat's expectations for P10 and P90. Other companies seemed to take an 'additive' approach to its risk assessment, which resulted in a much wider range.

We believe consistency of approach is important in this area, as will be the lessons learned assessing actual performance across AMP7 versus the risk profile assumed in company plan submissions. On cost assessment, there might also be similar outturns for companies in the sector that warrant more 'in depth' review. We believe that it will be important for Ofwat to review outturn across the sector to inform decision around PR24, including Ofwat 'self-challenge' as to what it got right in setting the Final Determinations and what it could improve on. One area that would merit greater focus is how past performance should influence cost assessment – i.e. avoid the risk of rewarding under-investment at the expense of longer-term financial resilience.

More prescriptive Risk Assessments Tools might also be helpful in ensuring that Ofwat receives consistent business plan submissions, with clear guidance as to how risks should be calibrated, measured and assessed – e.g. use of risk measurement tools such as Monte Carlo analysis.

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

UU is not in favour of equity indexation and does not consider this to be in the best interests of customers. We consider the existing approach remains consistent with the view of investors of the sector being relatively low risk, which has benefits for customers in a lower Cost of Capital (WACC). The Cost of Equity (CoE) is set primarily using CAPM and being able to observe listed company's beta demonstrates the sector's lower risk attributes relative to the broader market. This contributes to a lower WACC.

UU's equity investors are generally 'income' focussed and therefore favour stability in the Allowed Return for each 5-year price review cycle (subject to company performance). For publicly listed companies, dividend policy and associated metrics such as dividend cover are important considerations in respect of equity financeability. Introducing variability into the CoE has the potential to impair a company's ability to set a stable and sustainable dividend policy for the 5-year term, and thus change the risk profile for equity investors.

Further, indexing one variable component – the Risk Free Rate (RFR) - may not itself be sufficient to reflect changes in the CoE across the regulatory period, as other variables such as the Equity Risk Premium and beta are also dynamic. Further, studies suggest that notwithstanding volatility in respect of CoE components, Total Market Returns (TMR) are relatively stable in the long-run and this was the CMA's assessment. Therefore, we do not believe that introducing additional complexity into the regulatory mechanisms via adjustment to the CoE to take account of movements in the RFR is warranted.

It should also be noted that changes to other aspects of the wider price control; such as increasing the strength and asymmetry of ODIs and an increased number of reconciling items, mean that it is becoming increasingly less certain that the actual return an investor can receive. The inclusion of yet another reconciling item, directly targeted at the base return, will add more uncertainty and risk.

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

We note that at PR19 Ofwat set the embedded cost of debt allowance with reference to benchmark indices, using the iBoxx A and BBB 10-year plus indices with prominence on a 15-year trailing average, which was then reduced by 25 basis points (bps) for expected outperformance of the benchmark by the sector. Crosschecks were then performed to sector balance sheet data with no material difference found.

We believe that using the sector average cost of debt derived from companies' balance sheet data is a more robust basis for setting an embedded cost of debt allowance for the notional company, and we note Ofwat's intentions to enhance collection of debt data from companies at future APRs. Crosschecks to balance sheet data using relevant indices taken over an appropriate trailing period (reflecting the duration of debt in the sector) can also be performed to validate. So UU does not consider that Ofwat's approach needs to materially change in assessing sector embedded debt costs although greater prominence should be given to using sector balance sheet data.

However, in using companies' balance sheet data to set an appropriate embedded Cost of Debt (CoD) for the AMP7 regulatory period, Ofwat should ensure that the impact of derivatives on a companies' debt portfolio are fully factored into such analysis, given it will be the post-derivative positon that will be reflective of company's actual embedded debt costs. Ofwat should also be alert to how the embedded debt profile is projected to change over the AMP7 regulatory period (rather than assessing with reference to historic positions).

PR19 also introduced indexation on the new debt component using a composite of A and BBB 10-year plus iBoxx indices with an outperformance adjustment (which the CMA rejected). Whilst it is arguably too early at this stage to determine whether that benchmark will remain appropriate for PR24, issuance from the sector since April 2020 indicates that this approach has, so far, looked appropriate. The actual debt submissions in future APRs may also help to inform on this but it might need at least two to three-years' data to draw any meaningful conclusions. In setting the CoD allowance for the new debt portion, Ofwat should ensure that companies remain incentivised to raise new debt as efficiently as possible, given this benefits customers in the long-run in a better embedded debt position.

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

Whilst we would expect smaller Water Only Companies (WOCs) to provide evidence to support any uplift in the sector Allowed Return and/or Cost of Debt allowance, corporate finance theory would support such an uplift and we note CMA held similar views.

However, we believe Ofwat should give this question more broader consideration in the context of potential positive incentives in relation to: a) retaining listed equity in the sector, and b) demonstrating robust financial resilience. The benefits of retaining listed equity in the sector are threefold.

(1) Maintaining broad and diversified equity investor participation in the sector reinforces the sectors credentials as an investment proposition and acts as an effective and easily observable 'barometer' as to the sector's relative attractiveness to other sectors. Such broad based equity participation should also help in terms of longer-term financial resilience.

(2) Listed companies reinforce the sector's ESG credentials and advances in Corporate Governance can be directly evidenced by Ofwat so that such requirements can be set across the sector for the benefit of customers as a whole. UU has led the way on corporate reporting being early adopters of the Long-Term Viability Statement (LTVS) and the Taskforce for Climate Related Financial Reporting Disclosure (TCFD) in recent years. Further, developments in UK corporate governance and controls for listed companies will follow on the back of the recently published BEIS report aimed at restoring trust in audit and corporate governance (so called UK SOX).

(3) Having listed companies enables Ofwat to observe directly relevant 'benchmarks' in assessing an appropriate Allowed Return using sector listed company market data as a key 'input' into the CAPM equity pricing model, which helps to set a .

There are real costs to maintaining listed company status, and UU believes that given the importance of the above benefits to customers, a positive listed company incentive in the form of an uplift to the Cost of Equity would be beneficial in providing incentives to existing publicly listed companies to maintain this status, and potentially provide incentives for a relisting of private companies.

With regard to setting incentives for demonstrating robust financial resilience, this could be linked to companies' actual gearing relative to the gearing assumption for the notional company (see our response to Q11.7).

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

Generally, we believe the notional company capital and financial structure, and associated financeability assessment are a key underpin to the stability and predictability of the regulatory environment, and should be reflective of the sector risk profile and the balance of incentives, risk and return. The level of gearing should not be used as a method for addressing financeability issues. Rather, it should be a structure that is recognisable to stakeholders as being reflective of actual companies in the sector, in order to be credible. UU has generally sought to mirror regulatory assumptions in order to maintain financeability and ensure robust financial resilience, however, we do not know of any evidence to suggest that reducing the current level of gearing is appropriate.

Move to 50% index-linked debt

We would support a change in the financing assumptions of the notional company such that the component of index-linked debt is increased from 33% to 50%. This reflects the sector average and UU's own index-linked/nominal debt split. UU has had a longstanding policy of targeting having approximately half of its debt in index-linked form, having made a balanced assessment of the benefits of alignment with a regulatory model set in real terms, balanced against increased income statement volatility from having variable swings on finance expense due to outturn inflation. It should be noted that as demand for corporate index-linked debt is relatively scarce (most is in the hands of pension funds for long duration), index-linked debt in the sector has generally extended debt duration profiles and has been raised at a time of higher real rates relative to the current environment. We do not believe that companies such as UU that have pursued responsible financing strategies should be penalised for having a material portion of long duration index-linked debt.

This should improve adjusted interest cover (AICR) (as measured by Moody's) plus Fitch's post maintenance interest cover on a cash basis (cash PMICR), although not on a nominal PMICR basis. However, it should be recognised that the move to 50% index-linked debt will not improve Standard and Poor's (S&P) primary credit metric – funds from operations (FFO) to debt, as the inflation accretion (due to indexation) on index-linked debt is included by S&P in both the finance expense and the net debt position. So increasing the proportion of index-linked debt will only partially solve any financeability constraints.

Further lowering in the notional company gearing assumption

UU was supportive of the reduction in the notional company gearing assumption at PR19 from 62.5% to 60%. However, we are not supportive of a further lowering of the notional company gearing for PR24 to below 60%. There seems no compelling reason to justify why a lower level of gearing is appropriate and we believe that 60% is likely towards the lower end of the gearing range for the listed companies, as 60-65% is consistent with attaining solid investment grade credit ratings with both Moody's and Fitch from a financeability perspective.

To maintain the credibility of the notional company financing assumptions, we believe it important that the financing assumptions used are (broadly) reflective of the conventional capital structures employed in the industry, as purpose of the notional company is to demonstrate financeability with reference to an efficient company reflecting the totality of the price control, which must have some relation to actual companies in the sector.

Whilst we do not believe that a change in notional company gearing assumption is necessary, depending upon PR24 investment requirements, there might be a need to attract additional equity into the sector (i.e. to maintain a stable gearing profile). We note that in RIIO-2 Ofgem has provided a 5% equity issuance allowance to fund its view of issuance costs associated with additional equity required, and we believe that such allowances are appropriate to reflect 'real world' equity issuance costs.

We also believe that the CMA's principle of 'aiming-up' in setting the Cost of Equity and the Allowed Return as part of the PR19 final determinations would be an appropriate principle to follow, if material investment requirements/additional equity are identified at PR24.

When assessing each company's gearing relative to the notional company, reported pensions deficits should also be included as debt (consistent with the treatment by the credit ratings agencies) for the purposes of assessing a company's financeability under its actual capital structure.

Further, there should be explicit allowance to reflect the impacts of DPC on companies' actual gearing. Moody's has indicated that in relation to the HARP DPC project the lease liability created when the asset comes into use will be recognised as debt with a corresponding addition made on a notional basis to UUW's RCV. This will have the effect of increasing UUW's debt:RCV compared with the position had the DPC asset not been in existence and/or funded via the conventional debt:equity mix.

With regard to the use of revenue advancement via PAYG and/or RCV run-off, notwithstanding the CMA's position (which mirrors that of the ratings agencies, Moody's and Fitch), we do think this tool could remain beneficial to customers at PR24 in managing 'in-period' revenues and cashflows. In particular, from a 'real world' financeability perspective the use of such a tool might be beneficial to maintain FFO/debt at acceptable levels (S&P's prime credit metric) and/or improve dividend cover thus aiding equity financeability. However, such tools should not be over-used such that they are detrimental to longer-term financial resilience.

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

UU fully supports Ofwat's focus on financial resilience in the sector for the long-term, and we have a strong and consistent track record in this area over many years. However, the indications are that not all companies are in the same place and, if a company in the sector were to suffer financial distress, then this could have wider systemic implications. We therefore believe that any concerns regarding financial resilience in the sector are robustly addressed, and we note that some of the highly leveraged companies are beginning to take actions to lower gearing at the regulated operating company level, although this is often facilitated by issuing more debt upstream.

We note that the CMA in its PR19 final determinations rejected Ofwat's Gearing Outperformance Sharing Mechanism (GOSM) finding that the mechanism was not well designed to increase the financial resilience of the Disputing Companies and might even reduce it.

UU believes that a positive incentive mechanism would be more effective, whereby companies that maintain regulated company gearing close to the notional gearing assumption are rewarded with an uplift in the Cost of Equity. This will provide a direct incentive to align gearing more closely with the notional company, and it could be tiered to provide greater incentive to reduce gearing - e.g. [+25]bps on the Cost of Equity if gearing in maintained, say, within plus or minus [5]% of the notional company central gearing assumption, and [+10]bps on the Cost of Equity if gearing is maintained outside of [5]% but within plus or minus [7.5]% of the notional company gearing assumption, on average across the AMP. This could be prospective, based on company business plan submissions with an ex post adjustment to reflect outturn, or retrospective at the end of the AMP.

We believe that any incentive in respect of maintaining gearing at around the level assumed for the notional company should also take account of any companies' pension deficit position (as measured in its statutory accounts) as part of the debt position (see response to Q11.2). This reflects how the credit ratings agencies treat such obligations. Further, given that no regulatory allowance for pension deficit repair contributions will be provided to companies at future price reviews, we consider that the obligations for companies in respect of pensions deficit funding should be explicitly recognised as part of any incentive to promote financial resilience for the longer term.

Any such incentive mechanism should also be adjusted to exclude any adverse impact that DPC has on a companies' gearing position (noting Ofwat's intentions to remove DPC from such metrics as derived from regulatory returns).

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

UU is supportive of full transition at PR24 to CPIH indexation, although the market for CPI/CPIH-linked debt remains very thin and is unlikely to change absent the UK DMO starting to issue CPI/CPIH-linked gilts.

We recognise the UKSA's intention to align RPI with CPIH from 2030, and it should be noted that such an alignment might not in itself align existing RPI-linked debt instruments with CPIH. Depending on the terms of the applicable debt item, companies might be required to compensate RPI-linked bondholders for this change. If that were to happen, then any coupon adjustment would be reflected in post-change embedded debt costs.

In adopting full CPIH indexation, we would be keen to understand how RPI-linked metrics which feed into the allowed return (for example, index-linked gilts as a proxy for the RFR) are to be 'converted' from RPI-real to CPIH-real – i.e. what assumptions are made around the RPI-CPIH wedge and how will these be derived.

12. Next steps for PR24

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

We welcome Ofwat providing its draft timetable for PR24. It is now important that the respective roles and responsibilities of companies and regulators are clearly defined and that all parties commit to timely delivery.

It is clear that Ofwat will be providing a range of additional guidance and source material to companies on issues such as performance commitments, incentive rates and long-term planning assumptions that were previously issues for companies to lead on. In order for these to be properly reflected in business plans and for the price review to be delivered successfully, it is important that there is clarity on which areas Ofwat will be delivering, what the coverage will be, when companies should expect this to be delivered and when companies will be expected to respond.

We note that early submissions are expected in May 2023 – less than two years away. We consider that it is important to be clear, as soon as possible, about the coverage expectations for these submissions and when companies should plan and anticipate the necessary guidance and source material becoming available. We do not believe that such decisions can reasonably be left until the draft methodology publication – still less to the final methodology publication – and on this basis would urge that Ofwat should schedule an interim publication ahead of the draft methodology setting out its proposals on timetable, process and the respective responsibilities of companies and regulators. This will enable companies to manage their activity and workload around these key milestones, ultimately delivering the best possible business plans for customers.

We would also recommend that wherever Ofwat intends to provide early guidance (such as on performance levels, botex expectations, WACC etc) it should seek to do so sooner rather than later. Whilst the early submission at PR19 for cost adjustment and enhancement expenditure was helpful, it was announced late in the process. If companies have foresight of these submissions then they will be able to plan for this activity now, ensuring a higher quality submission. On the other hand, the early publication of the WACC assumption was well flagged in advance and allowed companies to develop plans and research approaches that made full use of this clarity.

14. Water Resources

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

As we highlight in our response to 8.2.1, setting disaggregated efficiency targets is not appropriate when looking to incentivise cost efficiency and development of the market within Water Resources. The setting of disaggregated efficiency targets would result in an unrealistic challenge whereby no single company can achieve the aggregated Water cost due to differences in operating conditions and the substitution effects present between the value chains. We would also note that the (lack of) ability to develop specific econometric models for Water Resources does not have any impact on management decisions or perception (ultimately, a Water Resources price control with separate allowances was still developed) and so issues concerning cost assessment should not be conflated with market problems.

In order to increase management focus on Water Resources as a business, the best way to achieve this would not be through further change but rather offering stability. Water resource planning (whatever the boundary definition) involves requirements over long timescales, much longer than the duration of a single price control. As such, companies are not planning their water resource needs just for the forthcoming AMP, rather they are actually more concerned with the AMPs after that. Uncertainty in future regulatory decisions and constant change will therefore actually hinder the development of the market rather than support it. Because of this, we think that the best way to incentivise companies is for Ofwat to consider what it can commit to for the long-term, for example, could it commit that the water trading incentive will be in place for more than just the forthcoming AMP? Being able to offer increased stability in the regulatory framework will provide companies and potential market participants with more clarity of future regulations and better enable the existing incentives to work as intended.

Through the development of regional Water Resource groups, such as Water Resources West, and the establishment of RAPID, significant steps have already been taken to help the market for trades to develop. Ofwat should first be willing to let these groups mature and for resource planning to develop in this more collaborative environment, rather than risking intervening when actually it might already have the right incentives in place, they can just take time to be realised.

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

Price control boundaries are set to increase visibility and send price signals to incumbent and potential market participants to intervene where a more efficient solution can be provided. Where the boundary should be set will reflect a view of where the market is most likely to develop, for raw or treated water. The reality is that there is likely to be both types of trade in a fully functioning market and so there is unlikely to be a one-size fits all boundary definition. Therefore, Ofwat should ensure that whatever the boundary definition, it incentivises the markets for both raw and treated water equally. We do not believe that there is any real sign that the current boundary definition is what is limiting current trading arrangements and planning for resources, it more realistic that time is currently the limiting factor. Water Resources (as currently defined) is an asset intensive value chain, utilising extremely long life assets and so decision making occurs over a much longer timescale than lesser asset intensive activities such as retail. Therefore, any change or incentive is naturally going to take longer to be reflected.

Currently, the boundary definition accounting for just the water resources value chain would lean more towards incumbent trading being the predominant type of market rather than treated water, which you would associate more with bilateral entrants. If this continues to be the case then a revision to the boundary for PR24 might not be appropriate, as this would necessitate revisions to the RCV splits made by companies at PR19 and potentially a more focussed approach. This obviously is not a small piece of work. Absent that, we are largely ambivalent as to where the boundary is actually drawn. We see benefits in all three options, but whatever the boundary definition, Ofwat should be explicit in why it is making its decision and set out its long-term expectations to provide more certainty over the direction that the market is heading and giving the stability to the regulatory framework to better support decisions to be made. As we mention in Q14.1, we believe that there are enough positives now through Water Resource groups and RAPID to warrant leaving things unchanged for PR24 and to assess the changes to the market over a longer time period.

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