Water UK

Water UK response to PR24 and beyond: Creating tomorrow, together

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Summary

Water UK is the representative body and policy organisation for water and wastewater service providers across the UK. This response sets out positions that are commonly held across the sector; individual companies may have other perspectives and this submission should be considered complementary to theirs.

We welcome the opportunity to respond to Ofwat's initial views on the framework for PR24 and future price reviews. We agree that the water sector faces profound challenges in the coming years and decades and that now is the time for action to ensure that these challenges are met. This must include rethinking the approach to price reviews – to achieve different, and better, outcomes for customers, communities and the environment, we will all need to do things differently.

We are encouraged that the ambitions for PR24 and beyond set out by Ofwat recognise this need for change, and much of the direction of travel in the document is welcome. The need to focus on the long term is widely recognised across the sector and beyond and was one of the key recommendations in our discussion paper[1] on developing a shared 2050 Vision for the sector.

However, an overall observation is that while the document is positioned as being about 'PR24 and beyond', the overwhelming focus is on the framework for PR24. To genuinely achieve the focus on the long term that we all recognise is necessary will need greater clarity about the long-term direction of regulation and the enduring principles that will apply over successive price reviews.

This long-term clarity is important to enable an evolution from discrete five-yearly price reviews to price reviews that are coherent staging posts towards long-term outcomes. This is particularly important because of the long-term nature of the sector and its investors.

The sector has been successful in attracting and retaining investors with a long-term orientation. This matches the long-term orientation of an infrastructure sector where today's investments provide services to many generations of customers.

Substantial investment will be needed not just at PR24 but in subsequent regulatory periods, and regulation should therefore create a supportive long-term investment environment. Given that long-term investors value stability and predictability, this will not only require the sector to continue to be

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[1] https://www.water.org.uk/wp-content/uploads/2021/03/Developing-a-2050-Vision-for-the-Water-Sector-Discussion-Paper.pdf

seen as an investable proposition, with a reasonable prospect of an appropriate balance of risk and returns, but also one with a clear and predictable long-term regulatory framework.

A key part of a predictable long-term regulatory framework will naturally be committing to incorporating in future price reviews decisions made in redeterminations, such as reflecting the CMA's position that financeability is as a matter of principle best addressed by setting the WACC at a reasonable level, so that both debt and equity investors should earn sufficient returns to cover the costs of financing.

We welcome Ofwat's recognition of the CMA's rejection of the specific alternative approach Ofwat took to financeability at PR19 (advancing future cashflows). We look forward to Ofwat's acceptance of the broader principle that the appropriate way to address financeability constraints is by setting an appropriate WACC - rather than, as Ofwat has suggested in the consultation, artificially adjusting parameters used in the calculation of WACC such as assumptions on gearing or index-linked debt.

Changes in the notional structure as described would move that structure further from a sensible basis consistent with observed sector performance or indeed capital structures observed in competitive environments and would be unlikely to be seen by investors as being consistent with stable, predictable and evidence-based regulation.

We welcome Ofwat's keenness to build at PR24 on the PR19 approach to funding capital maintenance and maintaining asset health by taking into account a forward-looking element to assist in triangulating results from the econometric modelling of historical costs. We consider this to be one of the key areas where, in the interests of current and future customers, there is a need for fresh thinking and a fresh approach. We have set out our initial thoughts in the annex to this response.

It is also clear that a decisive shift is needed across the whole sector to a genuinely outcomes-based approach, with a regulatory framework that enables, supports, and incentivises catchment and nature-based solutions being at the heart of delivery. This shift will need to recognise the different risk and cost profile of catchment and nature-based schemes compared to traditional capital schemes – and without such a shift, the tensions between competing pressures at PR24 may be hard to reconcile. We ask that Ofwat consider its approach to the introduction of 'price control deliverables' in this context, so that it does not undermine the benefits of an outcomes-focussed approach.

We note the recent recommendation from the Climate Change Committee (CCC) that Ofwat 'include decarbonisation as one of Ofwat's core principles, to assist the water industry's goal of decarbonising by 2030'[2]. Further thought will be needed on how the regulatory framework should contribute to the achievement of net zero; we have provided initial suggestions below and will continue to develop thinking in this area. We would also urge Ofwat, in focussing on net zero, not to neglect the importance of climate change adaptation. As Ofwat is aware, climate change brings significant risk to resilience, that will require both investment and innovation, which it will be important for the regulatory framework to enable, as well as to challenge as appropriate.

More broadly, the collective task for us all will now be to convert high-level ambitions into tangible reality. This will require incorporating fresh thinking and ensuring that every detailed element of the

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[2] Page 218, CCC Progress in reducing emissions, https://www.theccc.org.uk/publication/2021-progress-report-to-parliament/

price review, including those of the changes proposed by Ofwat that are ultimately taken forward after further consideration, are integrated and consistent with the overarching ambitions.

This should include a rigorous, evidence-based regulatory impact assessment of whether each of the specific proposals for change put forward by Ofwat materially assists in meeting long-term ambitions, has a more marginal impact, or risks unnecessarily increasing regulatory burdens or distracting the focus and attention of the sector away from those long-term ambitions.

Carrying out such a regulatory impact assessment would enable a prioritised set of changes to be identified, which would also build confidence in the deliverability of changes at PR24 to a demanding timetable. Such an impact assessment may also reveal options available to Ofwat in terms of *how* it introduces its proposals which could mitigate some of the burden or distraction effect, for example by providing early clarity on intentions, principles and approaches so as to allow companies to adjust in good time.

This 'in the round' assessment of deliverability, integration and consistency will be crucial to achieving the goal that Ofwat has rightly set out of each successive price review being a staging post towards long-term outcomes. In this context, we are pleased that Ofwat has recognised the importance of looking at cost assessment and service levels together, and the need to gather information and evidence to support a better alignment of costs with service level targets at PR24.

Below we provide more detailed responses, where appropriate, to the issues raised in the consultation. We have not sought to answer each specific consultation question, although for ease we have grouped our comments under the chapter headings used by Ofwat in the document.

Chapter 2: Ambitions for PR24

As we look towards PR24 and beyond, it is encouraging to see that there is much common ground within the sector regarding both the substantial challenges facing the sector – most notably responding to the climate emergency – and how the sector should respond[3].

Focusing on the long term was one of the key recommendations in our discussion paper[4] on developing a shared 2050 Vision for the sector. We agree that this should be a central theme for PR24, as planning over a longer period can result in lower bills, better intergenerational fairness, and more impactful solutions for customers and communities in the longer-term than the discontinuities that can result from viewing price reviews as 5-yearly reviews in isolation.

However, an overall observation is that while the document is positioned as being about 'PR24 and beyond', the overwhelming focus is on the framework for PR24. To genuinely achieve the focus on the long term that we all recognise is necessary will need greater clarity about the long-term direction of regulation and the enduring principles that will apply over successive price reviews.

[3] Although in relation to Figure 2.1 (page 13) we note that the water industry's Public Interest Commitment on water poverty is to '*Make bills affordable as a minimum for all households with water and sewerage bills more than 5% of their disposable income by 2030 and develop a strategy to end water poverty*'.

[4] https://www.water.org.uk/wp-content/uploads/2021/03/Developing-a-2050-Vision-for-the-Water-Sector-Discussion-Paper.pdf

This long-term clarity is important not just to demonstrate that the sector has evolved from having discrete five-yearly price reviews to price reviews being coherent staging posts towards long-term outcomes, but also to provide the necessary stability and predictability to maintain the confidence of long-term investors in the sector and to improve their ability to make decisions that genuinely take account of long-term factors.

We agree that the whole sector doing things differently in the future will enable the sector to deliver even greater environmental and social value. We are pleased to see the reference to the benefits of nature-based solutions; it will be crucial that the sector's regulatory framework enables, supports and incentivises catchment and nature-based solutions being at the heart of delivery – and that both economic and environmental regulation work together towards this goal.

We note the CCC's recent recommendation that Ofwat 'include decarbonisation as one of Ofwat's core principles, to assist the water industry's goal of decarbonising by 2030'[5]. Further thought will be needed on how the regulatory framework should contribute to the achievement of net zero; the Water UK 2030 Net Zero Routemap[6] highlights a number of important enablers where decisive action by Ofwat and other stakeholders will be needed in advance of PR24 to ensure the sector can play its part in delivering net zero.

We would also urge Ofwat, in focussing on net zero, not to neglect the importance of climate change adaptation. As Ofwat is aware, climate change brings significant risk to resilience, that will both require investment and innovation, which it will be important for the regulatory framework to enable, as well as to challenge as appropriate.

It is also clearly crucial that price reviews are underpinned by a clear understanding of the needs and preferences of customers and communities, and we recognise that Ofwat has a clear wish for some customer research for PR24 to be carried out centrally.

It will though be critical that any centralised research does not undermine or dilute the companies' own relationships with their customers and the ownership of those relationships. It will also be important that all companies have the option to be fully involved in the development of any centralised customer research, that it is carried out in a way that produces timely and reliable results, and that there is a clear path for local and regional preferences to be expressed in price review decisions. The results of any research (whether carried out centrally or by individual companies) should be considered on their merits, rather than results being artificially weighted depending on which organisation has carried out the research.

More broadly, the collective task for us all will now be to convert high-level ambitions into tangible reality. This will require incorporating fresh thinking and ensuring that every detailed element of the price review, including those of the changes proposed by Ofwat that are ultimately taken forward after further consideration, is integrated and consistent with the overarching ambitions.

This should include a rigorous, evidence-based regulatory impact assessment of whether each of the specific proposals for change put forward by Ofwat materially assists in meeting long-term ambitions,

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[5] Page 218, CCC Progress in reducing emissions, https://www.theccc.org.uk/publication/2021-progress-report-to-parliament/

[6] https://www.water.org.uk/routemap2030/

has a more marginal impact, or risks unnecessarily increasing regulatory burdens or distracting the focus and attention of the sector away from those long-term ambitions.

Carrying out such a regulatory impact assessment would enable a prioritised set of changes to be identified, which would also build confidence in the deliverability of changes at PR24 to a demanding timetable. Such an impact assessment may also reveal options available to Ofwat in terms of *how* it introduces its proposals which could mitigate some of the burden or distraction effect, for example by providing early clarity on intentions, principles and approaches so as to allow companies to adjust in good time.

This 'in the round' assessment of deliverability, integration and consistency will be crucial to achieving the goal that Ofwat has rightly set out of each successive price review being a staging post towards long-term outcomes.

Chapter 3: How we regulate

We agree that the overall 'building block' approach based on outcomes, costs and risk and return should be maintained. Given the importance of regulatory predictability to maintaining long-term investor confidence, it is sensible for changes to the regulatory framework to be evolutionary, and they should be accompanied by greater clarity about the long-term direction of regulation and the enduring principles that will apply over successive price reviews.

We comment under other chapter headings on various areas where we do see a need for evolutionary change to deliver better outcomes for customers, communities and the environment.

Further thought will be needed on how the regulatory framework should contribute to the achievement of net zero. The CCC's recommendation that Ofwat 'Ensures all regulatory decisions, and procurement decisions, are consistent with the Net Zero[7]' is well-aligned to the sector's commitment to decarbonisation.

The recommendation could be enabled by applying the HMT's Green Book[8] methodology to Ofwat and EA policy frameworks and publishing the analysis alongside consultations. Analysis via the Green Book will also establish common understanding on how policy frameworks will 'interact with all other long-term goals and ambitions[9]', and enable more detailed net zero planning across the sector. At the same time, in focussing on net zero, it will be important not to neglect the importance of climate change adaptation, and in particular the investment that will be needed to secure resilience in the face of climate change and population growth.

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[7] Page 218, CCC Progress in reducing emissions, https://www.theccc.org.uk/publication/2021-progress-report-to-parliament/

[8] https://www.gov.uk/government/publications/the-green-book-appraisal-and-evaluation-in-central-governent/the-green-book-2020

[9] Pages 31, PR24-and-Beyond-Creating-tomorrow-together.pdf (ofwat.gov.uk)

Chapter 4: Increasing focus on the long term

We strongly support the underlying premise of this section of the document that five-year price reviews should be staging posts within a long-term context, rather than seen in isolation – which requires a greater long-term focus and clarity on long-term outcomes.

However, as noted above, an overall observation is that to genuinely achieve the focus on the long term that we all recognise is necessary will need greater clarity about the long-term direction of regulation and the enduring principles that will apply over successive price reviews.

This long-term clarity is important not just to demonstrate that the sector has evolved from having discrete five-yearly price reviews to price reviews being coherent staging posts towards long-term outcomes, but also to provide the necessary stability and predictability to maintain the confidence of long-term investors in the sector, and improve their ability to make long-term decisions, e.g. on the sequencing of investments and ensuring intergenerational equity.

One of the key long-term outcomes for the sector to achieve is net zero. As all areas of company operations impact on net zero, the transition towards it will interact with all other long-term goals and ambitions – and to achieve optimal outcomes for customers, communities and the environment, the regulatory framework will also need to adapt.

A key first step would be to better understand the degree of commonality between the water sector's ambition, Defra targets and the Welsh and UK Government's targets. Our initial review shows that there are some differences in the way key stakeholders define and measure progress and it would be helpful to understand the degree to which the targets and timescales are either going to be agreed centrally or by each company and their customers.

To inform this, working with companies we will be doing more work to align top-down policy driven targets with existing customer research, to identify any common themes and principles for how customer choice could or should inform the pace and type of interventions that water companies prioritise.

Comprehensive and robust reporting of greenhouse gas (GHG) emissions will naturally be a key part of the sector's long-term approach, but we would reiterate our comment in response to the "Regulatory Reporting 2020-21" consultation that a phased approach to implementing changes to reporting of GHG emissions is needed, starting with reporting operation emissions through APRs and enabling consistent reporting of capital carbon emissions by 2025. As capital carbon emissions are closely linked to investment in new infrastructure, capital maintenance, and new connections, any future capital carbon performance targets should be established by individual companies as part of their PR24 business plans.

We note Ofwat's view that providing early guidance on some aspects of the price review process could streamline the process and enable greater focus on longer term issues. In order for this to be the case, it will be essential that there is early clarity on the detailed scope of pre-business plan guidance from Ofwat, and that this early guidance is evidence-based and provided sufficiently far in advance of business plan submission (and early submissions if required by Ofwat) for companies to be able to take it into account in developing their plans.

Given the centrality to business plans of many of the areas that Ofwat has proposed to provide early guidance on and the fact that this guidance will likely be driven by the availability of sector wide performance information, we suggest that this guidance needs to be provided no later than the summer of 2022, well in advance of business plan submission, and the timing, scope and delivery of centralised customer research will need particular care to align with those timelines also.

We also note that this centralised approach makes the development of every company's business plan contingent on the timely and complete provision of guidance from Ofwat, inevitably increasing delivery risk for the overall price review process by introducing a potential single point of failure.

To build and maintain collective confidence, we suggest that Ofwat provides progress updates to the sector on a regular (at least quarterly) basis, and, as suggested above, applies a rigorous evidence-based approach to prioritising which potential changes at PR24 are taken forward.

Chapter 5: Getting more for customers, communities and the environment

This chapter covers a range of proposals; we are not seeking to address all of these in this response as some will be better covered in responses from individual companies.

We note the proposal for 'targeted challenges' at PR24, similar to the challenge on leakage reduction at PR19. We recognise that targeted challenges could provide additional focus on specific areas where it was felt that further progress was needed. We would though make three observations.

Firstly, as a point of principle, it is not clear whether targeted challenges would be needed in an outcome-based regime if there were sufficiently meaningful incentives to encourage and enable innovation. Secondly, in order for companies to develop, and cost, proposals to meet a targeted challenge, early clarity on the scope of any targeted challenge will be essential.

Thirdly, consideration of a targeted challenge, especially if it represents a step change in expectations, should include assessing and allowing the additional efficient costs of meeting this challenge, as the CMA did in relation to leakage in its recent redeterminations[10]. If Ofwat takes forward a targeted challenge, it will doubtless wish to assure itself that customers would support the additional efficient expenditure required to deliver a higher level of service. We note that even in competitive sectors which Ofwat is seeking to mimic, if an external challenge imposes additional costs on all companies in the sector, this would be expected to have an impact on market prices.

The consultation proposes that for the initial business plan assessment, greater emphasis is placed on how well companies' plans position them to deliver in the long term. We agree that a long-term focus for the initial business plan assessment would be appropriate, and consistent with focussing on the long term being a key theme for PR24; furthermore, there should be a clear line of sight from desired long-term outcomes to decisions at each price review.

[10] https://assets.publishing.service.gov.uk/media/60702370e90e076f5589bb8f/Final_Report_---_web_version_-_CMA.pdf

One of the most important long-term outcomes for companies to deliver is net zero. Incentives could be a powerful enabler for delivering net zero; we suggest there are three key considerations to be borne in mind in establishing a balanced incentive package for net zero at PR24:

i. To understand which steps on the Net Zero Routemap[11] require action solely from the water sector and assess the existing risk/ reward package to see if additional incentives (or removal of regulatory barriers) are required, such as preventing GHG emissions from sewage treatment processes.
ii. To ensure there is consistency across all sectors who have a role to play. For example, it is clear from the Sixth Carbon Budget that renewables will be a big part of the decarbonisation plans, for example solar generation increases from 10 TWh in 2019 to 85 TWh in 2050, with on average 3 GW per year needing to be installed to reach this level of solar generation[12]. There is a recognition that this ambition cannot all be delivered by energy sector – as noted in National Grid's July 2020 Future Energy Scenarios – "All scenarios show higher levels of decarbonisation and decentralisation compared with today"[13].Therefore there is a logic for aligning incentives so that customers get the best renewable solution, irrespective of which sector delivers it.
iii. To better align the incentives with the timescale over which the benefits will accrue. For example, appropriately incentivising catchment or nature-based solutions that take longer to achieve the outcome, expose companies to a higher risk of failure and require working with and influencing third parties.

If, however, companies are constrained in their choice for how to best manage fluctuations in energy prices (e.g. through renewables being unfunded activity and existing Government incentives no longer being in place) then there is a case for reviewing the balance of risk and the extent to which different cost sharing or risk pass through is required. Moreover, as the move to net zero is likely to drive an increase in energy costs above inflation this should be reflected in the efficient cost allowances for PR24.

More broadly, there are lots of unknowns on the path to net zero, especially relating to process emissions. Positive incentives for companies to show leadership in pushing the boundaries of what can be achieved, and recognition that a degree of risk in doing so is inevitable, would be appropriate. We also suggest that net zero, as arguably the biggest challenge facing the sector and society as a whole, should continue to be an ongoing focus through the innovation fund.

Chapter 6: Reflecting customers' preferences

As we have commented previously[14], we can understand the concerns which have resulted in the proposal for collaborative research, and we recognise that in some instances more consistency may be beneficial and improve confidence in the results of research in some areas, including different local or

[11] https://www.water.org.uk/routemap2030/
[12] https://www.theccc.org.uk/publication/sixth-carbon-budget/ (page 135)
[13] https://www.nationalgrideso.com/document/173821/download (page 84)
[14] https://www.water.org.uk/publication/water-uk-response-to-ofwats-discussion-paper-on-reflecting-customer-preferences-in-future-price-reviews/

regional preferences. There are different ways in which this concern could be addressed, and there is a range of views in the industry on best approach.

As noted above, we recognise that Ofwat has a clear wish for some customer research for PR24 to be carried out centrally. At the same time, it is critical that any centralised research does not undermine or dilute the companies' own relationships with their customers and the ownership of those relationships. It will also naturally be important that the results of any research (whether carried out centrally or by individual companies) are considered on their merits, rather than results being artificially weighted depending on which organisation has carried out the research.

Given the importance of individual companies, and their Boards, owning their business plans, and the importance of there being a clear line of sight from customer views to those plans, it will be crucial for all companies have visibility of, and the option of directly contributing to, all aspects of the design of any centralised research.

This will be essential to build confidence across the industry in the approach that is ultimately taken. If companies lacked confidence in the results of the research because they were insufficiently able to participate in assuring its appropriateness and design, then it may be difficult for companies and their Boards to take ownership of the results and use them as the foundations of business plan proposals.

Furthermore, if there is misalignment between the results of Ofwat's national customer research and the messages that companies are hearing from their own customers, communities and wider stakeholders this could be a negative in terms of companies' relationships with these critical groups, which matters for their ability to deliver improvements that rely on enabling and encouraging behaviour change in communities and partnership working.

Given the centrality of customer research to the development of business plans, early clarity on the scope and timing of centralised customer research is crucial so that companies can plan accordingly. We would see any role for Water UK in this process as being one of facilitation rather than acting as a substitute or proxy for involving individual companies.

As noted above, a centralised approach would make the development of every company's business plan contingent on the timely provision of robust and reliable customer research, inevitably increasing delivery risk for the overall price review process by introducing a potential single point of failure. Early agreement of a timetable that will deliver customer research outputs in sufficient time to inform business plans, and then regular reporting of progress against that timeline, will be essential.

Chapter 7: Planning together for PR24

As the consultation notes, price reviews do not happen in isolation, and alignment across many parties and processes is needed to deliver a price review that serves customers, communities and the environment well.

We would observe that in the past, achieving 'joined-up' regulation has at times proved to be a challenge, but there is now a well-established principle that strategic planning processes like the Water Resource Management Process (WRMP) determine the 'need' for investment, while price reviews determine the best value way to meet that defined need over the long term.

We agree that engagement, assessment and feedback by Ofwat at each stage of the WRMP will be helpful, and this approach could also be usefully adopted for other strategic planning processes, such as the new Drainage and Wastewater Management Plan process.

In addition, we recognise the progress already made by RAPID in a short period of time, in no small part due to new ways of working and engagement across the sector to provide a seamless regulatory interface. This shows the power of collaborative working across regulators and companies – and approach which could be adopted more broadly.

We note the proposal to establish a 'PR24 Challenge Panel'. It is however somewhat unclear what purpose this would serve, and it would appear to be inconsistent with Ofwat's statement that 'it is the role of the water companies to seek challenge to their plans from other regulators and stakeholders in advance of submission'. We would welcome early clarity on Ofwat's thinking both in terms of any panel's substantive contribution to the price review and on how Ofwat sees it fitting into the process and timeline.

Chapter 8: Design and implementation of price controls

In relation to developer services, there is general recognition across the industry that the current regulatory approach is sub-optimal. Companies support the aim of the parallel consultation on 'Gathering information about developer services' of gaining a more granular understanding of developer services activities. While investing in better data inevitably has upfront costs, this more granular information will result a better assessment of the options for reform and assist in realising the goal of a better approach to regulating developer services.

In the longer term, there is broad support for de-regulating contestable elements of developer services activity, with non-contestable elements remaining within the network plus price control. This longer-term goal may however take some time to achieve, so it would be worthwhile also exploring further more incremental improvements, including an updated reconciliation mechanism.

In relation to the boundaries of the water resources control, we would note that changing the boundaries would involve a considerable degree of disruption and additional work, and that any impact on the allocation of the RCV would be particularly sensitive. It is not clear from the consultation that there is a compelling benefits case to justify this, and more broadly continual changes to the boundaries of price controls risk undermining perceptions of the long-term stability and predictability of the sector.

Chapter 9: Outcomes

We support the overall direction set out in this section of confirming a continued commitment to using an outcomes-based approach, while reducing complexity by moving to a smaller number of outcomes of enduring interest to customers.

As the consultation notes, at PR19 performance commitments served a range of purposes, and there is potential to use different mechanisms for each of these purposes, such as differentiating between performance commitments and price control deliverables. Regardless of the way elements of the price review are categorised, it will though be important that there is a still a mechanism for local or regional customer or stakeholder preferences to be expressed in price review decisions.

It will naturally be crucial that the approaches to outcomes and cost assessment are fully joined-up to avoid the potential for a cost-service disconnect, and to provide clarity on the respective roles of different funding mechanisms. We ask that Ofwat ensure that any steps to introduce 'price control deliverables' are done in way that does not undermine the benefits of an outcomes-based approach.

More broadly, we feel that there is real potential for governments, regulators and companies to work together to take an outcomes-based approach significantly further in delivering environmental benefits. We will be developing thinking further on this over the next few months and look forward to discussing this with Ofwat and other stakeholders in due course.

Chapter 10: Cost assessment

Before turning to specifics, we would make an overall observation that for PR24 to be a success, it will be essential for the detailed technical approaches to cost modelling and assessment to be fully consistent with the overall ambitions for PR24, such as focussing on the long term, delivering a step change in the use of catchment and nature-based solutions, and delivering the transition to net zero.

As noted above, it will naturally be crucial that the approaches to outcomes and cost assessment are fully joined-up to avoid the potential for a cost-service disconnect, and to provide clarity on the respective roles of different funding mechanisms. We note Ofwat's work to further improve and refine its modelling approaches, which is welcome; at the same time, it will naturally be important for Ofwat to be open to evidence submitted by individual companies where their efficient costs differ from those suggested by Ofwat's models.

Regarding net zero, we agree that the changes needed to deliver net zero could mean a change in the costs of providing water and wastewater services. For example, as the CCC has recognised, 'reducing wastewater treatment process emissions is highly capital-intensive'[15] and could involve disproportionately high costs compared to other abatements elsewhere in society – cost which will not currently be reflected in the base cost models.

We agree in principle with Ofwat that the 'primary focus at PR24 needs to be on driving carbon emissions down, rather than offsetting them'. However, unless the enablers highlighted in the sector's net zero routemap are tackled by government and regulators, progress on the most efficient options will be slow or impossible, forcing the sector to pursue less efficient options that have higher costs for customers.

We also agree that 'seeking opportunities to reduce carbon may reveal opportunities for reducing cost and increasing environmental benefits via nature-based solutions'. However, PR24 should not be predicated on the assumption that nature-based solutions are currently enabled 'in practice' by environmental frameworks across England and Wales, because significant regulatory transformation (by

[15] https://www.theccc.org.uk/wp-content/uploads/2020/12/The-Sixth-Carbon-Budget-Methodology-Report.pdf page 302

both environmental and economic regulators) will be needed to support a step-change in the approval of nature-based schemes.

This transformation should result in a regulatory framework that enables, supports, and incentivises catchment and nature-based solutions, including recognising their different risk and cost profile compared to traditional capital schemes. It will also be important for this regulatory framework to be a long-term one, to enable innovative approaches to nature-based solutions to be developed and implemented across control periods.

Without the transformation, traditional solutions will still be required to meet new demands (such as those arising from WINEP) so it cannot be assumed that costs or carbon emissions will be lower and because of the uncertainty, future regulatory demands were not included in the BAU case in the net zero routemap.

We fully support the recognition that achieving net zero will require some enhancement investment above and beyond base level and we expect that cost benefit assessments will continue to be a key part of making the case for these investments. There would be merit in Ofwat setting out any base assumptions they expect companies to use (or explain any variance to).

Through a Water UK working group, we will also be exploring the scope for accessing other funds to progress some aspects of net zero, to minimise the bill impact on customers. The July 2021 OBR Fiscal Risks report[16] indicates that earlier investment is better value for society than acting later and has a greater environmental benefit. Companies recognise that evidencing that this assertion will be part of any investment business cases, but would welcome early guidance on the type of evidence that may be required.

We welcome Ofwat's keenness to build at PR24 on the PR19 approach to funding capital maintenance and maintaining asset health by taking into account a forward-looking element to assist in triangulating results from the econometric modelling of historic costs.

We consider this to be one of the key areas where, in the interests of current and future customers, there is a need for fresh thinking and a fresh approach. We have set out our initial thoughts in the annex to this response.

Chapter 11: Risk and return

In considering the proposals in this chapter, we start from the overall position that given the well-known long-term challenges facing the sector, it is in the interests of current and future customers for continued investment to be encouraged and for the sector's longer-term attractiveness to investors to be maintained.

This will require the sector to be seen as an investable proposition, with a reasonable prospect of an appropriate balance of risk and returns – particularly in light of the substantial investment that will be needed in subsequent regulatory periods to meet the challenges of climate change and growth.

[16] https://obr.uk/frr/fiscal-risks-report-july-2021/

There is a well-established regulatory principle, maintained in the recent redeterminations by the CMA[17], that there is an asymmetry of risks to consumers from over-or under-estimating the cost of capital, and that a degree of 'aiming-up' is therefore appropriate and in consumers' interests. Stable and predictable regulation should create a supportive long-term investment environment and the allowed return needs to be set in a way that encourages the right level of new investment.

Financeability provides an important cross-check on the choice of the cost of capital and the overall balance of risk and return in the price control. In particular, price reviews need to include consideration of whether assumptions on WACC are consistent with the credit rating that is assumed, noting the importance of WACC in those ratings (rather than other mechanisms which hold out the prospect of returns, such as ODIs). As the CMA reflected in their redetermination, as a matter of principle, if the WACC is set at a reasonable level, both debt and equity investors should earn sufficient returns to cover the costs of financing.

In this context, we welcome Ofwat's recognition of the CMA's rejection of the specific alternative approach Ofwat took to financeability at PR19 (advancing future cashflows), and look forward to Ofwat's acceptance of the broader point made by the CMA that the appropriate way to address financeability constraints is by setting an appropriate WACC - rather than, as Ofwat has suggested in the consultation, artificially adjusting parameters used in the calculation of WACC such as assumptions on gearing or index-linked debt.

Changes in the notional structure as described would move that structure further from a sensible basis consistent with observed sector performance or indeed capital structures observed in competitive environments and would be unlikely to be seen by investors as being consistent with stable, predictable and evidence-based regulation.

On a separate point, we note that Ofwat has suggested transitioning to full CPIH-indexation for PR24. To do so would, other things being equal, increase upward pressure on customers' bills in the short term (with a corresponding reduction in returns over the longer term due to the RCV being indexed by a lower measure of inflation). Given the range and magnitude of likely upward pressures on bills at PR24 from investing to deliver customer and stakeholder priorities, it may be appropriate to allow flexibility on a company-by-company basis to mitigate the impact on customer bills at PR24 by varying the pace of the transition.

Chapter 12: Next steps for PR24

It is helpful for Ofwat to set out a draft timetable for PR24. Our key observation on this timetable relates to Ofwat's proposals to provide early guidance on base costs, PCLs, ODIs and financing costs, and to centralise some parts of customer research.

It will be essential that there is early clarity on the detailed scope of this pre-business plan guidance, and of the centralised customer research, and that outputs are provided sufficiently far in advance of

[17] https://assets.publishing.service.gov.uk/media/60702370e90e076f5589bb8f/Final_Report_---_web_version_-_CMA.pdf

business plan submission (and in advance of early submissions if required by Ofwat) for companies to be able to take them into account in developing their plans.

Given the centrality to business plans of many of the areas that Ofwat has proposed to provide early guidance on and the fact that this guidance will likely be driven by the availability of sector wide performance information, we suggest that this guidance needs to be provided at the latest by the summer of 2022, well in advance of business plan submission, and the timing, scope and delivery of centralised customer research will need particular care to align with those timelines also.

We also note that this centralised approach makes the development of every company's business plan contingent on the timely and complete provision of guidance from Ofwat, inevitably increasing delivery risk for the overall price review process by introducing a potential single point of failure. To build and maintain collective confidence, we suggest that Ofwat provides progress updates to the sector on a regular (at least quarterly) basis, and applies a rigorous evidence-based approach to prioritising which potential changes at PR24 are taken forward.

Annex Approach to setting capital maintenance allowances at PR24 and beyond

We welcome Ofwat's keenness to build at PR24 on the PR19 approach to funding capital maintenance and maintaining asset health by taking into account a forward-looking element to assist in triangulating results from the econometric modelling of historic costs.

We consider this to be one of the key areas where, in the interests of current and future customers, there is a need for fresh thinking and a fresh approach at PR24. We have set out our initial thoughts on what a 'forward-looking element' might mean in practical terms in this annex and will continue to develop thinking further.

Our thinking has started from considering the incentive properties of the current approach, and in doing so we are encouraged that in chapter 5 of the consultation Ofwat recognises that these incentive properties may result in sub-optimal outcomes and that changes may be needed. Our overall observations are that:

- Companies are incentivised by the price control framework to meet or exceed a broad-based basket of performance commitments, and cost sharing rates provide a powerful incentive to do so in line with the benchmarks of efficiency set at the price review.
- Beyond a certain minimum, the volume of capital maintenance that a company undertakes need not exert a significant influence on a company's ability to meet its targets during an AMP, as management teams have at their disposal a range of means of delivering the desired level of service in the short and medium.
- This means that in practice, companies tend to be guided first and foremost in their maintenance planning by the 'budgets' that emerge from Ofwat's cost assessment process.

One implication this is that the PR14 and PR19 approach of setting botex allowances with reference to the expenditures incurred historically by lower-spending companies has the effect of locking in a slightly declining trend in capital maintenance activity over multiple AMPs (as seen in the significantly lower volumes of maintenance that companies do now in comparison to 20 years ago).

We recognise that this is not a conscious decision on the part of Ofwat, based on its assessment of underlying engineering needs. Rather, it is a consequence a wholly backward-looking, benchmarking-led approach to setting base expenditure allowances having been adopted, where the expenditure of lower spending companies effectively drives the sector 'budget'.

The case for a rebasing of activity levels

On the face of it, the current approach may not be disadvantaging current customers in terms of measured outcomes, asset health and bills. There is not currently a crisis of under-performance (or over-spending). There is nevertheless a strongly held view across companies that the prevailing levels of and the trend in capital maintenance activity within the sector are sub-optimal. This is for two reasons:

- first, current low replacement rates mean that the average age of the industry's asset base is increasing and, therefore, the average remaining life is decreasing, with implications for asset condition; and
- second, this is happening at a time when the demands that companies are having to meet in relation to service, environmental outcomes, climate change and resilience are increasing.

Even if companies are able to manage for the time being with low capital maintenance levels, the view is that this is at the expense of increasing levels of risk. There is also an intergenerational unfairness in that this generation is not acting as good long-term stewards of the nation's assets, nor are they paying for a fair share for the wear and tear that their consumption causes. The concern is that this will eventually come to a head and future generations of consumers will suffer service failures and/or have to pay the bill for higher maintenance expenditure.

In essence, everyone, including Ofwat, will unavoidably need to make a choice at PR24. One could make a bet that the current approach can continue indefinitely and be consistent with good quality and resilient outcomes. Or one could decide that it is unsustainable for the average age of the assets to keep on rising, and that the increasing level of risk involved will either in due course result in asset – and therefore service – failures or a cliff edge of cost increases. The experience of both the rail and airport sectors in the 2000s demonstrated the suddenness with which asset condition risks could crystallise and the resulting actual and reputational impacts for all the parties involved.

A potential approach for PR24

To avoid these risks, we suggest that PR24 should be a review in which there is a consensus amongst all parties – companies, customers and regulator – that there should be latitude in the approach to the setting of the portion of botex allowances that pertains to capital maintenance in a different way, recognising that forward-looking maintenance requirements may be different from historical levels of activity. In particular:

- there should be a degree of flexibility within the business plan framework for companies to increase the amount of funded maintenance activity that they do starting from 2025/26; and
- the regulatory regime should afford customers with strong safeguards around value for money in the event that a company opts to use this flexibility.

We have given some initial thought to how this could be taken forward in practice. Companies consider that the cost adjustment claim framework, with some modification, provides most of the architecture that is needed to bring a "forward-looking element" into the PR24 cost assessment process:

- it leaves the backward-looking historical cost models intact, ensuring that (a) the setting of allowances builds from an initial picture of the prevailing level of efficient costs and (b) any changes that are made to accommodate a revised assessment of capital maintenance expenditure do not interfere with the assessment of other types of costs;
- it puts the onus on individual companies to demonstrate that they have well-developed, robust plans; and
- it potentially allows Ofwat to give companies different allowances based on relevant company-specific differentiating factors.

Companies consider, however, that capital maintenance ought to be marked out clearly as a special case within the PR24 methodology, in that:

- Ofwat would need to signal in advance that it accepts that the direction of travel ought to be towards higher capital maintenance activity and is therefore pre-disposed to accept properly formed claims; and
- successful claims would result in one-sided adjustments to cost allowances.

These two things together mean that the process for approving capital maintenance plans would be separate and materially different from the standard cost adjustment framework, consistent with a mutual understanding that there is – at industry level and in general terms – a need for higher maintenance spend.

The criteria that companies should apply when developing proposals, and, later, the tests that Ofwat would apply when challenging plans, might cover matters such as:

- capability – a company should demonstrate sufficient maturity in asset management (so that customers can be reasonably confident that the company can be trusted with additional expenditure);
- clarity – the plan should identify clearly what a company is proposing to do and how it proposes to do it, why it is different and new, the relationship with longer term asset stewardship and resilience strategies, and how additional capital maintenance fits within the broader outcomes strategy, even if individual spending elements cannot (given their scale relative to the total asset base) be tracked through precisely;
- justification – demonstration of benefit to customers, including evidence of customer acceptance;
- deliverability – a company should show that its plans are physically deliverable given the complexities of much capital maintenance work whilst assets continued to operate; and
- efficiency – evidence of cost optimisation.

Boards would naturally need to offer the usual assurance on all of these points. Companies also recognise that there may be exceptional cases in which it may be appropriate to consider further whether there is a link between past under-spending and future, higher maintenance requirements.

However, for the sector overall this issue needs to be considered against the background of the incentives given by the regulatory framework over time and the fact that companies and regulator together have managed to sustain and improve service levels despite lower spending through improved management of costs, enhanced assessment (and acceptance) of risk and deployment of operating cost-based techniques – and customers have benefited from lower than otherwise bills. Moreover, the sector is now facing more challenging conditions. A focus on the past is therefore likely to be at odds with the more forward-looking strategic approach that changing circumstances and challenges requires.

Safeguards for customers

Companies understand that regulatory recognition that the future is likely to be different from the past and acceptance of a need for forward-looking approaches to capital maintenance is bound to mean that any additional funding they receive cannot be a blank cheque. It would be untenable, in particular, for incremental allowances for additional maintenance activity, if not spent in full, to translate into shareholder profits.

The industry's existing incentive and risk allocation rules are not obviously equipped to deal with the changes proposed under the previous heading. The over-arching regulatory philosophy at the moment is primarily focused on outcomes – i.e. a company that is able to deliver performance commitments at lower-than-anticipated expenditure gets to keep up to half of its underspend. By contrast, the appropriate risk allocation for capital maintenance would ideally see companies:

- do the work they said they would undertake or otherwise return to customers any monies associated with lower-than-anticipated volumes of work; while
- still facing incentives to deliver maintenance work efficiently.

The 'uncertainty mechanisms' that Ofgem uses in energy network price controls may provide one way of achieving the desired risk allocation. These mechanisms provide for totex allowances to adjust automatically down (or up) in proportion to the volume of activity that a company undertakes (e.g. the number of km of pipes that are replaced) using pre-set formulae in which an allowed unit cost is effectively fixed in advance but the final totex allowance depends on the output delivered.

Further work would need to be carried out to ascertain if such formulae could be deployed in a water industry context. However, companies' initial view is that there are a number of areas in expenditure that are amenable to this type of approach.

PR29 and beyond

While the current focus is on PR24 and mechanisms that could accommodate a more forward-looking element to setting capital maintenance spend, that may only be the first step. There is likely to be a need for a continuing, longer-term, cross-sectoral look at asset maintenance requirements and trends, so that future price reviews, and the mechanisms they use, derive from a well-grounded understanding of capital maintenance needs in the context of climate change, changing service requirements, and asset and service resilience.

Some of the evidence presented in PR24 may begin to inform this longer-term assessment to provide an even firmer grounding for PR29, with companies' consideration of asset resilience increasingly needing to extend many years, potentially decades into the future to capture the potential impacts of climate change and other developments

Next steps

We hope that the thoughts set out in this annex are helpful in developing a shared understanding of what a 'forward-looking element' to the assessment of capital maintenance needs might mean in practice; we are conscious that given the timeline of PR24 there is only a short period of time in which to develop this shared understanding.

Working with companies, we would be happy to develop this thinking further over coming months, although before doing so, we would welcome early engagement with Ofwat on whether the overall approach set out in this note could form the basis for a shared understanding on the future approach to the assessment of capital maintenance needs.