PR24 and beyond – consultation on initial views – Wessex Water response

22 July 2021

Summary

We welcome the opportunity to respond to your consultation on the framework for PR24 and future price controls.

We agree that "PR24 has to deliver for customers, communities and the environment in the face of considerable and urgent challenges". The scale of the challenges: climate emergency, carbon neutrality, long term resilience and rising customer and environmental expectations cannot be underestimated. Nor can the urgency, so it is essential regulators take the opportunity to introduce significant reforms at PR24.

Economic and environmental regulation must make this step-change together. The water industry in England recognises that it needs to raise its game on the environment and has signed up to a vision to become globally recognised environmental leaders by 2050. In its 25 Year Environment Plan, the government has committed to leaving the environment in a better state. Water companies can make a major contribution to the Government's environmental targets, in particular the recovery of nature within a generation.

The current approach to environmental regulation is inefficient, prescribing inputs and outputs and focusing almost exclusively on investments in physical infrastructure. This approach leads to perverse outcomes, such as increasing carbon pollution through energy consumption and embedded in construction of the assets. In the face of climate change, the water industry cannot build its way out of this problem, and it cannot do it alone. Investment in catchment solutions in general, and nature-based solutions in particular, can achieve substantially more for the environment at a lower cost. PR24 needs to mark the point at which catchment and nature based solutions become mainstream and the full potential of WINEP reform is realised.

We commend the ambition you set out in your document and the direction of travel is welcomed. It is though, as always, the detail behind that ambition that will determine the eventual success of the price review. We need a decisive shift across the whole sector to a genuinely outcomes-based approach, with a regulatory framework that enables and incentivises catchment and nature-based solutions at the heart of delivery.

This is a win-win-win reform agenda. Firstly, innovation will be incentivised as a core part of the regulatory architecture, as opposed to the current regulatory regime in which the incentives are being whittled away by mechanisms that reduce risk for poor performers and reduce rewards for high performers. Secondly, customers, communities, and the environment will benefit from better outcomes. And, thirdly, regulators will be able to demonstrate that they have enabled the sector to deliver great improvements at record levels of efficiency.

We also need to recognise the need for long term and sustainable investment in infrastructure if we are to maintain resilience in the face of a rapidly changing climate. Renewing only 0.6% of water mains and 0.2% of sewers each year is simply not sustainable in the longer term; and of course we need to start to address the issue of harm caused by CSOs. As part of PR24, it would be good to have a 25-year infrastructure resilience strategy.

Whilst PR24 must deliver for customers, communities, and the environment, we must not lose sight of the private investment that finances these outcomes and should ensure that the price review maintains investor confidence. The sector has done a great job of maintaining confidence through the highs and lows of economic and regulatory cycles. But we must be careful not to take this for granted or as a given, particularly in a world where future interest rates are much more likely to rise than fall. Giving clarity around your commitment to long-term investment is critical and needs to be confirmed.

Investors look to the water sector for stable, predictable, and evidence-based regulation. Your approach to assessing financeability must reflect that and avoid arbitrary changes to the notional structure to address constraints caused by other elements of the price review.

PR24 should be seen as an opportunity to rethink the approach to economic regulation. Almost 35 years since regulation of the water industry began, there has not been a better opportunity to ask ourselves how we would set the regulatory system up at the time of privatisation with the benefit of seven price controls' worth of hindsight.

There are several excellent concepts that have been developed over that time, which should be retained – providing an allowed return on an RCV, using appropriate incentives aligned to outcomes is exactly the model we propose. However, there are several areas that need to be stripped back including swathes of the reconciliations, true-ups, and uncertainty mechanisms that currently stifle innovation. Equally, the perverse incentives created by financial ODIs on input and output metrics need to be removed. On the other hand, there are added sophistications that are essential if the high-level ambition is to be realised. From nature-based solutions, through to catchment markets, the regulatory system will need to enable, encourage, and incentivise innovative approaches – in particular, towards delivery of long-term environmental outcomes.

We hope to see a Strategic Policy Statement from Defra that sets out clearly the expectations for the sector as a whole – including regulators – in delivering benefits for customers, communities, and the environment. We then expect both Ofwat and companies to be held to account in delivering business plans and determinations that meet both the letter and the intent of the statement.

The rest of this document builds on these thoughts and we look forward to further collaborative work on developing the optimal solution for PR24.

Section 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 completely agree that "PR24 has to deliver for customers, communities and the environment in the face of considerable and urgent challenges". The urgency cannot be understated, and significant reforms must be implemented at PR24 to ensure that the sector faces up to these challenges before it is too late. We must be clear that if the opportunity is not taken now, but left to PR29, then it will be 2030 before the sector even starts to make the improvements it must.

Whilst the themes suggested for PR24 are sensible, it is the detail behind them that is critical.

An "increased focus on the long-term" must mean that we acknowledge our role as stewards and providers of essential services is an ongoing one, and not one that resets every five years. It should not be a trojan horse for incentivising specific actions or interventions on the part of companies. We agree with the idea of maximising long-term benefit through the increased use of nature-based solutions, so long as the rest of the price review is set up in a way that supports this. The alignment with strategic planning frameworks and long-term outcomes is critical, not least because those strategic planning frameworks invariably need investment over the very long-term in very long-term assets. This too, should be reflected in the way incentives are designed.

"Delivering greater environmental and social value" should not be taken as an opportunity to enforce a specific approach to delivering social value, but we strongly support the theme if the intention is that we tackle the urgent challenges facing us all by enabling, encouraging, and incentivising companies to play their part, in the way that works for their customers, communities and environments. The concept that companies should "routinely consider the wider, long-term benefits to communities and the environment when putting forward solutions, using a systems-oriented approach" is one that we wholeheartedly endorse and fully recommend as part of the PR24 methodology. In assessing efficiency of options, we should all be considering the secondary and tertiary benefits (like biodiversity, carbon reductions, etc.), rather than just the financial cost of the option. We strongly support the use of markets and are glad to see that you "support companies working in partnership and coordinating with organisations, both inside and outside the sector, to deliver common goals" and that "PR24 will need to ensure companies have the freedom to choose options which deliver multiple benefits". We are clear that these will be critical to delivering positive societal outcomes. We are strong advocates of reform to the Water industry national environment programme (WINEP) and believe that is the key to unlocking significant gains in overall efficiency (i.e. considering all costs and all benefits, over the long-term).

Again, it is the detail behind "reflecting a clearer understanding of customers and communities" that matters. As we regularly demonstrate, our customer research is of high quality, high frequency, and high impact. It is not just for price controls but conducted on an ongoing basis, across all customer segments, and all aspects of our role as public service providers. We support a more targeted and efficient approach to customer research as long as it focuses on the long-term outcomes that customers, communities, and the environment demand of us. We were pioneers of the social tariff and introduced an innovative version of our main social tariff for those affected by COVID-19, as well as a rebate for NHS employees whose bills rose as a result of increased uniform washing requirements.

Improvements, efficiency, and innovation are all concepts that are central to delivering our purpose and vision. However, they need to be better understood and correctly applied and incentivised in the price review methodology. Again, the opportunity to "work in new and innovative ways to deliver better outcomes and best value for money, including through partnership working, use of nature-based solutions and markets, and working with customers to change behaviours" is one that we will grasp if presented with the right incentives against the right long-term outcomes. Transformational innovation should be central to delivery of those long-term outcomes. The need for separate incentives to promote innovation is itself a sign of regulatory failure (the idea of fixing the symptom, rather than the cause, over and over again). As set out in the document, we fully advocate the idea that you "can allow companies the flexibility to choose the best ways of delivering outcomes, reward innovation and focus attention on areas where improvement is needed most pressingly".

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

We could not agree more strongly that "a focus on long-term outcomes should drive what water companies do" and would argue that we need significantly more clarity on how the regulatory framework will enable, encourage, and incentivise that than is currently available. In particular, this clarity is required on the approach to targeting and incentivising pure outcomes, on the use of catchment markets, and on the use of long-term holistic value in options appraisals.

Setting long-term incentives against long-term targets on long-term outcomes will do this, and the five-year price controls can then act as staging posts towards companies' long-term strategies.

PR24 should be seen as an opportunity to rethink the approach to economic regulation. Almost 35 years since regulation of the water industry began, there has not been a better opportunity to ask ourselves how we would set the regulatory system up at the time of privatisation with the benefit of seven price controls' worth of hindsight.

There are several excellent concepts that have been developed over that time, which should be retained – providing an allowed return on an RCV, using appropriate incentives aligned to outcomes is exactly the model we propose. However, there are several areas that need to be stripped back including swathes of the reconciliations, true-ups, and uncertainty mechanisms that currently stifle innovation. Equally, the perverse incentives created by financial ODIs on input and output metrics need to be removed. On the other hand, there are added sophistications that are essential if the high-level ambition is to be realised. From nature-based solutions, through to catchment markets, the regulatory system will need to enable, encourage, and incentivise innovative approaches – in particular, towards delivery of long-term environmental outcomes.

Simplification should focus on those areas of the regulatory system that are designed fix the symptom, rather than the cause, of perceived or actual problems. Simplification should not be seen simply as removing stages of the price review process.

We hope to see a Strategic Policy Statement from Defra that sets out clearly the expectations of the sector as a whole – including regulators – in delivering benefits for customers, communities, and the environment. We expect the statement to be ambitious in its tone and direct in its requirements. We then expect Ofwat, quality regulators, and companies to be held to account in delivering business plans and determinations that meet both the letter and the intent of the statement.

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 we measure progress against high-level and long-term outcomes, set against a well-defined baseline. That progress should evaluate the holistic (including the social, environmental, and financial) costs and benefits of the approaches taken, compared to the counterfactual of the regulatory system that exists today.

Progress should include that accuracy of proxies improves as more and better data are collected. It should include improvements in efficiency, where efficiency is considered holistically and includes all costs and all benefits over the long-term (rather than just the financial cost of a defined asset).

Importantly, the success of the sector should be measured using a few key metrics that are of most relevance to customers – high quality reliable services, affordable bills, great customer service, and an improved environment.

It is important that the metrics used to measure success are:

- Robust (i.e. transparent and credible),
- Recognised/used elsewhere
- Quantifiable
- Repeatable over time
- Show impact on outcome-based targets
- (for environmental outcomes) be easily valued or linked to existing markets

For example, affordability should not be conflated with average bills. Affordability should be interpreted literally, as customers being able to afford their bills. We support the approach set out by CCW that affordability should be measured as the proportion of customers whose water bill is more than 5% of their disposable income. This meets all the above criteria and, most importantly, reflects the true outcome.

We should, finally, evaluate the success of the regulatory system by comparing the efficiency of delivery of the outcomes to the letter and intent of the SPS.

Section 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?

Outcome- and incentive-based regulation is the bedrock on which our sector operates. However, when the concept was properly introduced at PR14, the regulatory architecture placed a huge focus on inputs and outputs. This inevitably removed the focus on delivering the outcomes that customers, communities, and the environment really want.

We are avid proponents of outcome-based regulation and support a system that values long-term outcomes with long-term targets and long-term incentives.

There have been some high-profile reports regarding the regulatory systems and the role they play in delivering outcomes in this country recently, including the Dasgupta review and the Penrose review. There is a consistent and well-argued narrative around the use of markets and innovation to drive improvements in outcomes. We concur that markets and innovation are critical to the continued success of the sector in delivering positive outcomes, and that both should be encouraged, enabled, and incentivised. They should not, however, be forced.

The innovation competition introduced to the water regulation model is a result of stifling incentives and is a prime example of regulation adapting to fix the symptoms of a problem, rather than the cause. Without innovation, the industry will stagnate, and outcomes will not be delivered to their full potential. However, we counsel that innovation and markets will develop naturally (as they did in the early days of regulation) if we focus on removing some of the more recent regulatory mechanisms whilst setting the first principles concepts in a way that encourages them, rather than forces them.

It will be important to consider holistic value and efficiency – not just the financial cost of building a thing. We must include the financial, environmental, and social costs and benefits if we are to find the most efficient combination of options to deliver all our outcomes. Focusing on financial cost alone ignores the secondary and tertiary benefits, leading to inefficiency and unrealised benefits. This poses a significant risk to the idea of Ofwat publishing its initial views on PCLs that correspond to the base costs ahead of business plan submission. It is very unclear how this might consider the holistic costs and benefits, rather than the principal activity cost allocation basis. We have evidenced how this works in catchment market trials and would be happy to share more information around the process and outcomes of those trials.

The building block approach is theoretically sound but badly enacted in practice due to ever-increasing regulatory mechanisms that seek to fix the symptoms, rather than the cause of regulatory failures (i.e. opportunities for companies to game the system). For example,

We discuss cost assessment in further detail in section 10. Whilst the cost assessment process needs work, much could be unlocked using catchment markets so that most environmental delivery is done at the efficient (market) price.

The risk and return framework should put long-term incentives on long-term outcomes, rewarding companies that do well and penalising those that do not. We note that a regulatory incentive scheme is, by definition, a good one if companies that expect to perform well see an opportunity to outperform, whilst companies that are not performing well on outcome delivery feel like negative incentives present a risk. These are clearly the desired effects of a well-designed incentive system.

Delivering the right outcomes:

The current approach does not incentivise outcomes properly as it also incentivises inputs and outputs, often with conflicting incentives. We give examples elsewhere in this response relating to the performance commitments and incentives around unplanned outage (which perversely incentivises some companies to run inefficient asset maintenance and replacement programmes), and PCC (which during the pandemic led to all companies seemingly failing as a result of people having to spend more time at home, even though the true outcome – sustainable abstraction - was unchanged from previous years as the increase in household consumption was offset by a decrease in non-household consumption).

In some cases, it is true to say that "the framework pushed companies to go further than ever before to deliver what their customers wanted" but in many cases, it is not. For instance, many performance commitment levels (PCLs) were set at arbitrary levels with little or no regard for what customers had asked for. The same is true for incentive rates. For example, our customers told us through in depth deliberative research that they could see no value in, and did not want to pay for, a 15% reduction in leakage given that it would not improve (and in the case of carbon, worsen) environmental outcomes and affordability.

Reducing the number of performance commitments is critical to:

- Focus on the things that matter to customers, communities, and the environment
- Give companies the flexibility to deliver as efficiently as possible
- Remove perverse incentives
- Focus company leadership

We believe that long-term incentives are critical to delivering long-term outcomes. Whilst this goes beyond ODIs (e.g. cost assessment, sharing rates, PAYG ratios, etc.), we would support ODIs that were RCV-based to ensure long-term focus, put onus on shareholders, and force – by definition – a focus on resilience and asset health. We talk more about RCV incentives in section 10.

Assessing costs:

We give significant focus to the topic of cost assessment in our response to section 10 but, in summary:

- Cost assessment as it stands has major flaws
- Large sections of cost assessment could be drastically improved by using markets to determine the efficient cost
- It needs to value nature-based solutions and credits/permits as assets to ensure incentives to invest are strong over the long-term
- Resilience should be inherent in delivering long-term outcomes

Assessing allowed returns:

We give more detail later, mainly in response to section 11 but, in summary:

- The system needs to properly understand risk before it can assess appropriate reward
- It also needs to understand full range of risks, and how those might be different across companies due to size, or delivery methods.

Use of markets:

- Markets should be enabled, encouraged, and incentivised – but not forced
- Experience to date has shown that where markets are forced, they tend to be inefficient
- Water resources and bioresources markets have not delivered benefits to date
- The developer services market has opened competition but the regulation of new (albeit small) monopolies is all but non-existent and very risky for the long-term outcomes that customers, communities, and the environment expect
- However, a proper catchment market, trading in real things, with clear rules and sufficient supply and demand will work if it is allowed to.

Systems operator model:

- We support the use of a catchment system operator and are ambivalent about the where the accountability sits, so long as its responsibilities align with the catchment market approach
- Regional water resource groups make sense but are typically looking at developing very long-term, large scale supply options and this is where most of their benefit sits.
    - RAPID has been, and will continue to be, excellent at expediting this process and we fully support it
    - However, it (or its equivalent) is not the solution to more run-of-the-mill environmental improvements within catchments

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?

We welcome Ofwat's focus on collaboration and encourage the main thrust of this to be on catchment partnerships and markets. As explained above, cross-sector coordination is critical and must be managed appropriately for the specific area of focus.

- For example, RAPID works for strategic supply options but is not appropriate for local catchment solutions. However, it is critical that the WINEP aligns with the PR24 structure and the DWI approach

Catchment markets run by a catchment system operator with all sectors involved will deliver the most efficient outcomes for customers, communities, and the environment.

We also believe there are lessons to be learnt from within the sector and encourage Ofwat to help facilitate data sharing with this specific aim in mind.

Our reliance and influence on other sectors are broadly well understood across the industry and we influence consistently on cross-sectoral policy, from energy to affordability and everywhere in between including with our supply chain. We believe the core incentive package, aligned to outcomes will provide sufficient promotion from Ofwat.

Section 4: Increasing focus on the long-term

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

We welcome the aspiration for greater focus on the long-term, where five-year price reviews are staging posts within a long-term context, rather than seen in isolation. This will require a greater long-term focus and clarity on long-term outcomes. This will have a number of key benefits as set out below:

Firstly, this will enable us to shape our plans on delivery of the outcomes that are important to customers and for the environment. In relation to these, the longer term focus will enable more innovative and sustainable solutions to be developed. Investment within the five-year period won't necessarily deliver benefit in the same price control as there may be a time lag. In some cases, this means that performance needs to be detached from spend in a given period and the focus on delivery of long-term targets will enable this. For example, in the case of river water quality, we will seek to minimise harm from storm overflows. The two main options to reduce harm from spills are separation of surface water and attenuation of combined sewage. Whilst both will have long-term benefits, the implementation period will be particularly long for separation of surface water and the benefits not fully realised for some time.

Secondly, as customer expectations grow and the need to both enhance and protect the environment increases, the number of drivers to enhance the levels of service that companies deliver will increase. This will present an upward pressure on average bills. This will require a greater long-term focus and clarity on long-term outcomes. Investment to deliver the enhancements required should be phased in relation to the long-term targets defined for the sector, prioritised to deliver maximum benefit in relation to the key outcomes. If spend is split over multiple price controls in this way, this will help manage the pressure on bills.

Thirdly, the long-term focus will enable us to optimise our approach to investment in long-term infrastructure, where the balance of risk and reward is different. To recognise this, there could be a separate price control for long-term infrastructure set over a longer time period, say 25 years. Short-term price controls and targets cannot reflect improvements and asset health metrics cannot measure it – so action is postponed. We could determine investment levels by long-term needs (based on deterioration modelling), rather than historical levels, with market tested delivery in a longer-term price control.

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

Long-term strategies should reflect the key outcomes that are important to customers and other stakeholders. We believe the following are the key outcomes that should form the basis of company plans:

- Great customer service
- Affordable bills
- An effective sewerage system
- Safe water supply
- Reliable water supply

- Sustainable abstraction
- Good environmental water quality
- Net zero carbon
- Increased biodiversity

The strategies should seek to cover current and future requirements, including legislative drivers. For example, the Environment Bill will provide a framework for key environmental outcomes off the back of the government's 25-year environment plan.

We support the use of common requirements for comparison purposes and to enable the sector to deliver on shared outcomes, for example the net zero carbon commitment.

The Water UK 2030 Net Zero Routemap[1] 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.

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. A review by Water UK identified that there are some differences in the way key stakeholders define and measure progress. Common requirements will enable progress towards delivery of the commitment to be monitored at a company and sector level. In addition, this will help to reveal best practice for minimising emissions, ultimately helping the sector to deliver against the target.

There also needs to be joined up thinking between different regulators and consistency, at least in the definition, of the targets that are set. Under the current AMP, companies have common performance commitments for pollution incidents and sewage treatment works compliance that are also measures used by the Environment Agency for the Environmental Performance Assessment (EPA). The measures were originally defined differently for the EPA and the PC, which is confusing for stakeholders.

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

This could build on the work completed in strategic planning frameworks in several ways:

4.3.1 Planning horizon

As highlighted in the consultation, a number of strategic planning frameworks, including the WRMP and DWMP, are based on a long-term planning horizon with review at a defined interval (25 years and five years respectively). The work completed as part of the WINEP taskforce has proposed extending the planning and delivery horizon to 10 years, updated on a five-yearly cycle.

The price review process could adopt a similar principle where plans are developed for key outcomes over the relevant long-term planning horizon and these are then reviewed every five years. This would build on the concept of our Strategic Direction Statement, which is based on a 25-year planning horizon and reviewed and updated every five years as part of the price review process to reflect latest thinking.

4.3.2 Collaboration and joint working

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

The framework should encourage companies to collaborate with others, planning on a local, regional and/or national basis to address the key challenges the sector faces. This is already an established part of the framework for water resources. The WRMP guidance states:

"When you develop your plan, you should consider how it will contribute to national and regional water resources needs, while delivering local benefits"

The regional planning approach is being further developed for strategic water resources through the RAPID gated process. This enables the best value solutions to be developed, for example strategic solutions that potentially serve the water resource needs of more than one company. The process takes a long-term view of environmental need and can also consider the needs of wider society and deliver greater public value.

Such an approach is also being promoted as part of the WINEP taskforce, which is seeking to incentivise the use of nature and catchment-based solutions. Planning at a catchment scale will enable companies to collaborate with other partners to deliver the wider outcomes in the catchment in a holistic and joined up way.

The key benefits of such an approach could be replicated across other areas of the price control. However, a key area to consider is certainty of cross price control funding for less capital-intensive solutions and we need clarity on how this would work.

4.3.3 Evidence based

The sustainable abstraction element of the WINEP is based on sound science informed by the investigations programme. A key outcome of this previously for Wessex Water was the GRID project, which was effectively the creation of a new major trunk main connecting previously single sources of supply. The GRID enabled abstraction to be reduced and a more flexible network developed. The basis for this was agreed licence reductions to protect the chalk aquifer.

Within the current ongoing WINEP, requirements for undertaking sustainable abstraction investigations are reviewed every five years and, where abstractions are proven to be unsustainable, future reductions in abstraction licences are agreed. This process works well and is based on a firm evidence base measuring the impacts of abstraction.

With the EA's environmental destination approach, companies are looking at how much water might need to be given back to the environment over the long-term (to 2050) to protect chalk streams etc. It is important, therefore, that the evidence base remains based on science with the five-year investigatory cycles defining actual licence reductions set within a longer-term framework of possible licence losses. Our WRMP's and Regional Plans should continue to be used as the mechanism for defining what is needed to plug any gaps in terms of predicted water supply deficits, factoring in our extended demand reductions and other drivers (such as impacts from climate change and drought vulnerability) over the longer term. These plans will have their own evidence base in terms of defining both the scale of the planning problem and the options required to address this.

4.3.4 Long-term aspiration

Both the WRMP and DWMP processes set a direction of travel, but outputs are not defined at the outset as these are uncertain.

For example, this approach could be used in relation to the issue of harm caused by storm overflows, which the sector is coming under increasing pressure to address. Historically, targets to address this issue have been linked to reducing the number of spills, focused on the overflows that cause most environmental and public health harm. The traditional way to reduce spill frequency is through the use of attenuation tanks, which have a high carbon impact. Defining the outputs in this way at the outset, does not necessarily deliver the right (most sustainable) solution.

An alternative approach would be to set a long-term 'direction of travel' for companies to deliver surface water separation to address this issue. Progress would then be tracked against the percentage of the network separated rather than number of spills, in the knowledge that this will – in the long-term – improve the outcome by reducing the harm caused by spills. This process is already being used as part of the DWMP process where the 'planning objective' is defined as how much of the connected area e.g. roof, road is removed.

An additional example is the setting of longer-term outcomes related to reductions in abstraction impacting chalk streams (part of environmental destination), although it is important that any metrics around this take into account the ongoing need for sound science to access the levels of sustainable abstraction on an ongoing basis as WINEP investigations have done.

The price review process could build on this as an approach by setting aspirations for the long-term. Companies would then optimise the investment required to deliver the target, considering the different outcomes (e.g. water quality, carbon, and biodiversity) in a holistic way.

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

As highlighted, the need for flexibility to adjust in light of new data and information is key. Setting a review interval or planning round of five years as for e.g. WRMP and DWMP will enable strategies and plans to adapt to new information that result in material changes. Such new information may include new government targets, new and innovative approaches to investment, updated cost/benefit information and/or change in use of assets (land, water).

We strongly reject the idea of reopeners and uncertainty mechanisms beyond those that exist currently – the level of uncertainty in water is significantly lower than in electricity, for example (consider the uncertainty around whether, when, and to what scale, electricity companies will need to roll out nationwide electric vehicle charging – this does not exist in any aspect of water and would only serve to add to the regulatory burden).

The WRMP 'Adaptive planning' framework is an example of how strategies and plans may consider different scenarios. This considers different drivers including societal and environmental. The plan proposes a scenario, but a range of other options are presented for consultation in order to identify the best value option.

Governance and assurance can support the need to hold companies to account to deliver expected benefits in the future. Deliverables will need to be clearly defined and monitored to enable this, with careful consideration of the evolution of outcome delivery.

Overall, we suggest that existing mechanisms could be developed to enable strategies and plans to adapt to new information.

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

If comparable aspects of companies' plans are provided in advance, this will reduce uncertainty and help focus discussion on key areas of difference. Such an approach would streamline the process.

Having Ofwat's views on base costs, incentives and WACC will be key if the proposal to combine the IAP with the DD is adopted. But, the decision on whether to streamline the IAP and DD stage will necessarily depend on the level of change in the methodology. 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 provided sufficiently far in advance of business plan submission (and in advance of early submissions if required by Ofwat) for companies to be able to take it into account in developing their plans. Companies would need to be involved in discussions on these key areas, for example through the cost assessment working group.

A key concern in regard to early views is that of Ofwat publishing its initial views on PCLs that correspond to the base costs ahead of business plan submission. We cannot see how this will be possible if Ofwat also commits to consider social and environmental costs and benefits at secondary and tertiary levels. Whilst we would value this approach if it was able to do that, we remain unconvinced that the proposed approach to cost assessment is sufficiently robust to do so.

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

There are benefits to this and elements of a collaborative approach could apply to regions that companies in England operate in. See response to 4.3 above.

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

Please see our comments below on the approaches suggested:

(i) *fixing parameters such as ODIs over several price reviews* – ODI values are currently linked to customer preferences. As highlighted by the consultation, customer expectations are changing, and incentive rates need to keep pace with this change. We strongly support the ambition to provide long-term clarity over the regulatory framework and feel this is best achieved through the range of incentive mechanisms, rather than just ODIs.

(ii) *specifying indicative levels* – this could be feasible and there are already a number of examples where this has been done by the sector e.g. the net zero by 2030 commitment The ambition could be set at an industry level and apportioned across companies and their catchments in many cases, particularly around the environmental outcomes. Each price review should be seen as a staging post on the journey to a long-term goal. Indicative levels are therefore a sound way of setting expectations, so long as they remain flexible enough to deal with innovation, changing social attitudes, and legislation. Importantly, this means they must also be flexible enough to deal with changes in the market.

(iii) *provision of more detailed guidance* – clear guidance is key but there is a risk that this adds more complexity and this must be balanced according to the points we make in other parts of question 4.

(iv) *delayed payment of incentives* – this is already embedded in the process through use of the RCV and would be more so with well-designed long-term incentives. As we noted in relation to surface water separation to reduce harm from storm overflows, the outcome will not change for several years and we support the use of proxies to demonstrate progress towards delivery of the outcome.

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

A shift away from default asset solutions to use alternative approaches, such as nature-based solutions, introduces the possibility of delivering much greater environmental and social value. However*,* the mechanisms to cost environmental and social value are not established and the associated costs and benefits are not reflected in investment decisions.

Consideration should be given to the use of use natural capital approaches as a way to maximise societal value. As part of this, the optioneering and appraisal of solutions should:

- align with the 25-year Environment Plan and the Net Zero targets including decarbonisation
- include consideration of nature-based solutions and the health of natural assets,
- consider collaborative options and delivery by the full range of parties who can affect the water environment.
- evaluate costs and benefits over the medium- to long-term under a range of scenarios

In addition, there may be issues related to the certainty of funding for delivery of solutions that have greater environmental and social value. For example, the use of opex solutions and how these are incorporated into the RCV. We consider this further in Section 10.

Finally, such solutions may carry more uncertainty and inherent risk because the evidence of their efficacy is limited. But, inherent risk should not be seen as barrier as well-designed incentives can provide mitigation to any chosen level of residual risk. For example, in order to meet bacterial water quality standards for bathing waters, the conventional solution is UV treatment. But a maturation pond could be used, which would have wider benefits in terms of e.g. carbon and biodiversity.

To enable this, the approach to environmental regulation would need to change, including valuing such wider benefits. There would need to be regulatory buy-in to such an approach where permits are set in a way that recognises how such systems operate and recognises potential variability in performance. Overall, risk appraisal should be clear about who ultimately owns the risk, particularly in collaborative solutions.

Section 5: Strengthening incentives

In this section we talk in depth about how incentives, if they are set up to support the delivery of the correct long-term outcomes that customers and society demand and are calibrated correctly to incentivise long-term resilience, can supersede the need for other specific incentives, focuses, and targeted challenges.

We discuss what the correct long-term incentives are in response to section 10.

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

If PR24 looks like PR19, we see no need to undertake an initial assessment of plans. It would be an opportune area to ease some regulatory burden and streamline the process.

However, we think that if there are significant changes to the proposed methodology; the initial assessment stage is crucial. It gives companies another round of the conversation ensuring that their plan delivers for customers, communities, and the environment. If the initial assessment stage were to be removed, we would want to have clarity around some key elements including: outcomes from customer engagement, expectations of common outcomes and performance metrics, totex models, and a view on returns before submission.

Removal of the initial assessment of plans does not remove the ability to offer incentives for high quality plans. This can be done at the draft determination stage as you highlight in option 3.

We would expect the focus to be on:

- track record of delivery,
- demonstration of future efficiencies,
- clear plans for delivery of long-term outcome targets against service, affordability, and environmental improvement,
- clarity of options appraisals, and
- appropriate consideration of social and environmental costs and benefits.

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?

We are strongly in support of this. If a company has demonstrated that it can deliver efficiently for customers, community and the environment then lighter touch regulation should be encouraged. However, this should not necessarily be linked to individual input/output measures – it should look holistically at a company's evidence of efficient delivery of financial, social, and environmental outcomes.

It should be both forward and backward looking, and should include appropriately evidenced business plans that give sufficient confidence of efficient optioneering around delivery of key outcomes.

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?

As mentioned in our response to question 5.1, if PR24 is set up with a long-term focus on delivering outcomes and their incentives, encouraging partnership working and nature based solutions then we would favour keeping the additional step in the process. It retains the strong incentive properties for high quality submissions.

If the regulatory architecture is set in a similar way to PR19, we would favour further streamlining of the process.

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

Fundamentally, we see no reason for the approaches in England and Wales to diverge. However, this will depend on how the relevant environmental regulatory systems are designed.

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

We support incentives where companies have a strong track record of delivering outcomes for customers and have provided compelling evidence that their plan is ambitious and deliverable.

This should start with allowing more ambitious and innovative solutions that have a lower evidential bar or, necessarily, make use of proxies for longer-term or unmeasurable delivery. This will then flow into earlier views of draft determination and a streamlined process (in terms of totex allowances and outcomes) if these are adopted.

We do not think that there should incentives attached to higher returns. Companies should be incentivised to submit efficient and stretching plans, delivering the best for customers, the community, and the environment, however, attaching additional returns to this incentive could instead create an incentive to submit "cheap" plans that are designed to receive these incentives but are not deliverable.

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?

Companies should have the ability to retain part of any savings and foot the bill for part of any overspend. This is key in a regulatory regime that supports efficiency and innovation. Cost sharing incentives are truly distinct from incentives around performance and should remain so.

How exactly cost sharing rates are set will depend on the how cost assessment is undertaken. If it is similar to PR19, then 50:50 sharing rates are appropriate as they protect both companies and customers and allow for trade offs between areas supporting an in the round assessment. However, we think that cost assessment should continue to improve, and the final cost sharing rates should depend on the final method.

If long-term performance incentives are created and calibrated correctly, potentially using adjustments to the RCV to create a long-term liability until performance is improved, then these will provide the incentive to ensure that the health of the underlying assets is maintained and we see no need to use totex sharing rates as a backstop.

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

With the correct focus on delivering long-term outcomes for customers and society and appropriate long-term incentives there will be no need for further specific targeted challenges on the inputs to delivering these. The focus on the long-term outcomes are themselves the targeted challenges as these should be at the heart of the plan.

We strongly disagree with the need for either of the targeted challenges proposed in the consultation document.

Water efficiency is only one way to solve the outcome of ensuring we abstract the right amount of water from the environment. The outcome should be the focus, with companies having the flexibility to propose differing ways to achieve it and optimising their delivery strategies to ensure that they deliver the best outcome for all stakeholders.

Similarly, for discharges from the wastewater network, reducing these is one way of delivering either better water quality in the environment or no sewer flooding. As above, the outcome should be the focus giving the companies the flexibility to propose the most efficient way of delivering the whole set of outcomes.

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

We agree that innovation should sit at the heart of what we do, driving efficiencies and better service for customers. However, we do not think that specific incentives around it should be set up. The need for separate incentives to promote innovation is itself a sign of regulatory failure (the idea of fixing the symptom, rather than the cause, over and over again).

The suite of incentives elsewhere in the price control, specifically totex and performance, should be enough to incentivise innovation. If they are not creating a strong enough incentive, then they are calibrated incorrectly. This calibration should be considered before introducing a separate innovation incentive.

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

As mentioned before, if the correct long-term outcomes are incentivised with correctly calibrated long-term incentives, this should de facto ensure that the outcomes of EBR are being delivered. Importantly, this includes collaborative and partnership working, delivering public value, and an aligned interest between investors, companies and wider stakeholders.

It will ensure that companies are doing and delivering the right things, with a focus on the long-term and are delivering fair returns.

Section 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?

As we regularly demonstrate, our customer research is of high quality, high frequency, and high impact. It is not just for price controls but conducted on an ongoing basis, across all customer segments, and all aspects of our role as public service providers.

We support a more targeted and effective approach through collaborative customer research as long as it focuses on the long-term outcomes that customers, communities, and the environment demand of us.

It is paramount that companies are given full visibility of the scope and timing of the collaborative research programme as soon as possible to make sure local engagement programmes can interact appropriately, there is no duplication of research projects and outputs are available on time for development of company Plans. Companies will also need to know when their input is needed in the development of the collaborative research and associated materials both from a resource and data perspective.

In terms of scope for the collaborative research, we can see merit, for example, in using it to identify the long-term outcomes and an associated set of common PCs, willingness to pay and potentially acceptability (and affordability) testing of Plans.

For willingness to pay we do not believe a collaborative survey simply to inform ODI rates is sufficient. WTP research is used in many more aspects of the business planning process. It is critical in the optimization of our investment plan to ensure that we are delivering the best value for customers, the environment and society. Therefore, the survey needs to cover all these aspects and be done early in the process, to ensure that we have time to set out an optimized plan. We would propose no later than publication of the final methodology.

Bespoke local engagement/co-creation might then be needed to refine a company's public purpose, understand how customers want their water company to achieve the agreed outcomes in the longer term, explore and explain any differences in the findings from the collaborative research projects, engage on company specific issues to inform plans and potentially agree any bespoke performance commitments if they remain in the methodology. It would be in addition to the day to day engagement with customers on items like ongoing service improvement, or water efficiency.

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

We prefer centrally commissioned research reporting at company level as opposed to a standardised methodology. Although a standardised methodology would give companies more ownership over the research including procurement, it may still lead to doubt over the validity of the results, questions over whether the methodology has been interpreted correctly, and may be more expensive to deliver. There may also be timing differences across the industry making it more difficult for direct comparisons to be done at any one time.

Centrally commissioned research would give true commonality in methodology and comparability of results. Companies will need to be assured that local variations are adequately identified, and that local engagement will be given sufficient weight through triangulation.

Sample sizes must also be robust at individual company level within the collaborative research from the outset, instead of giving the option to boost. In the past centrally commissioned research has had very small sample sizes at company level e.g. 200 customers with the option to boost. Not all water companies have chosen to boost which leads to inconsistencies in accuracy of results and lack of comparability.

Care would need to be taken with any collaborative study as to how to accommodate the different issues/attributes to include for all water companies, and how the research will deal with different starting/base positions and desired end position.

Governance needs to be clear and robust and water companies must feel they have a voice and influence on any centrally commissioned research projects and the overall engagement programme. We are comfortable with Ofwat's suggestion of a steering group, independent advisory group and a delivery group. We would like to be a key member of the steering group.

We note that Water UK are expected to be involved but we believe all water companies must have the opportunity to comment/input into each tender, research scope and all associated materials such as discussion guides, questionnaires, and stimulus material etc through this governance structure so that they are comfortable with the information being shared with the various audiences through research. Sufficient time will need to be built in to accommodate this.

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

We believe negotiated settlements are a powerful way to create business plans that truly deliver for customers, communities, and the environment. They bring communities and stakeholders into the core of decision making, reduce regulatory burden, and better reflect local views.

However, we understand the current regulatory position and suggest that the next best approach is that the long-term outcomes and targets should be set centrally, to a level that delivers the best outcome for customers, the environment, and society.

However, how these are delivered should be for the company to find the most efficient solution, and here we think it is key that companies engage with local communities to deliver these in the most efficient way, that delivers the best outcomes for everyone. They should be able to negotiate and agree local delivery strategies and key deliverables (outside of the outcomes framework).

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

We note Ofwat's desire to step back from independent customer challenge groups (CCGs), but we believe they still have a role and we have already been through an independent recruitment process for the Chair of our CCG and are refreshing membership.

The CCG will continue to hold us to account for delivery of our existing Plan and help us develop our plan for 2025-30 particularly challenging and providing assurance to us on our customer engagement. Once the minimum standards are developed, we may be able to meet those through our CCG and a revised terms of reference or we may need to put additional measures in place again demonstrating the urgency for this information.

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

Water companies will still be undertaking a variety of local engagement alongside the collaborative programme. Given the concern about reliability and comparability of research findings, appropriate triangulation of findings, particularly if overlaps occur with local and collaborative research, and demonstrating a clear line of sight from customer engagement to a finished business plan, we agree it is necessary for Ofwat to develop a set of minimum standards for all of these areas. This seems a more expansive list than proposed in the consultation.

We also agree minimum standards are needed to provide companies visibility of Ofwat's expectations on independent customer challenge and independent assurance so that we can modify the terms of reference for our CCG and/or put other steps in place.

We note the CCW best practice guidance on triangulation and its intended use.

With any form of minimum standard, we may choose to go above and beyond this minimum through innovation if we wish.

This approach should ensure that any engagement carried out at a local level is considered robust and where findings have been used in triangulation, that they are deemed to be reliable with significant weight.

If minimum standards are to be developed that work has to be done as soon as possible. We are already undertaking a significant piece of research to inform our Purpose and Strategic Direction for the next 25 years talking to customers, businesses, retailers, stakeholders and employees.

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

Our comments reflect the situation in England. As non-experts in the Welsh system, we won't comment on its applicability in Wales.

Section 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?

As you identify, it is critical that the strategic planning frameworks come together in a coherent way. Not least because those frameworks set out requirements on companies that have significant cost and outcome delivery implications.

We support your work with other regulators and have also been working closely with Defra and the EA to ensure the strategic planning frameworks are as aligned in delivering outcomes from their perspective as possible too. We have been key contributors to the WINEP task force, DWMP methodology working groups, and the like.

Overall, the key is that government, regulators, companies, and other stakeholders work collaboratively to ensure the whole sector is aligned in the outcomes that are required and the most efficient way of delivering the overall set of outcomes for all customers, communities, and the environment.

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?

Whilst we expect companies to have leading roles in developing their parts of the strategic frameworks with other regulators, we are pleased to note your intention to engage with other regulators too and note Ofwat's statutory duties to secure companies properly carry out their statutory functions, and that they can finance that carrying out of duties.

We would therefore expect Ofwat to continue the collaborative approach it has taken over the last 18 months or so to ensure this is the case.

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 can see benefit in a challenge panel so long as its terms of reference are to provide challenge in both directions (i.e. to the regulator and to companies), and that minutes of meetings are shared in full. We expect, however, that the resource requirements for such a panel would be immense (our experience from our own CCG is that it takes significant combined time commitments, and this would be bigger by a factor).

It will be important to consider where a panel can add most value, and that will depend on the design of the regulatory architecture. It will need revisiting when more is known about the proposed methodology.

Section 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 are strong advocates of markets and believe they should be encouraged, enabled, and incentivised. However, history of trying to force markets has so far borne little fruit.

The continued development of competitive markets will drive innovation and ensure long-term value for customers. To this end we can see value in separate price controls or moving parts of the value chain outside of the price controls, where there is a realistic market that can be developed. This will ensure that costs and service can be understood to support the development of a competitive market.

With this backdrop, we do not fully agree with the current set of price controls.

Given the struggles of the non-household retail market, the barriers to universal metering, and the proposal to move back to a revenue cap for retail, we see less of a rationale to keep this as a separate price control.

With the boundary of the water resource control where it is, we cannot see the water resource price control delivering the intended results. Crucially, the quality of the abstracted water will determine the treatment required and, without a homogenous product being created, we cannot see it working. However, this could be mostly resolved by moving the boundary of the control. The issue then becomes one of the viability of the market. Given that neither of these solutions provide a viable market, we recommend removing the separate water resources price control.

Having only one water price control would not mean that we cannot consider parts of the value chain independently.

We do see some value in reducing the complexity here. It reduces the risk and perverse incentives that cost allocation issues create and can remove some perceived barriers to more holistic solutions, such as combined resource and treatment solutions.. One such solution would be utilizing the growing market for environmental credits to deliver the long-term environmental outcomes. Initially this can be done within the network plus controls, but it could be an area for future consideration.

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?

As we discuss in answer to question 8.1, we do not think that there is evidence to support a separate water resources / treated water price control.

Regarding developer services we think that, at least the contestable elements, should be removed from the single till revenue cap. This protects all customers from variations in levels of activity in this area. This does not necessitate a separate price control.

The current approach, of increasingly excessive and detailed data gathering just increases regulatory burden. The market in this area is growing, we are now seeing the majority of projects going through alternative delivery routes.

To really push a functional open market for these areas we think it is important for regulation to take that step back and let competitive market forces work for customers.

Although we see the rationale for proposals on bioresources, there are some key considerations to take into account.

It is fundamental that in this asset intensive business the appropriate level of investment, both in capital maintenance and improved quality is supported. The risk is that a short-term focus, driven by only considering the immediate depreciation and not taking a long-term view of it (as is done by adding investment to the RCV) results in under-investment and not delivering key societal outcomes such as net zero. This could arise from not protecting efficiently created and required assets, or from the move to a focused efficiency challenge setting an overall unachievable level of efficiency across bioresources and wastewater network plus.

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?

Although we agree that simplification and standardisation is always welcome, we need to be mindful that these large projects are, by definition, unique and stand-alone. There is a risk that an overly prescriptive standardised approach will in fact create more regulatory burden that could be avoided by considering potential unique circumstances.

Section 9: Outcomes

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

We strongly agree that PCs should be focused on providing financial incentives for a select number of outcomes that will continue to matter to customers. We agree that the number of performance commitments should reduce and we broadly support the 'enduring outcomes' proposed (with a few minor exceptions, detailed below, and noting that the list is not exhaustive), which align reasonably closely with our own thoughts as detailed in section 4.

Ofwat outcome/PC	Wessex Water outcome
Reliability of water supply	Reliable water supply; safe water supply
Preventing sewer flooding	An effective sewerage system
Providing great customer service	Great customer service; affordable bills
Encouraging water efficiency	Sustainable abstraction
Environmental enhancement including greenhouse gases	Increased biodiversity; net zero carbon; good environmental water quality

We note that water efficiency is not an outcome, but an output that helps us deliver the outcome of sustainable abstraction. Whilst it is a critical part of our approach to improving the environment, we would therefore suggest that it is not subject to a financial incentive. We have seen through the pandemic that PCC is a poor performance commitment in terms of driving delivery of the real outcome. During the first 12 months of the pandemic, household demand soared by over 10% leading to significant failures of the PCC performance commitment. However, this was offset by even more significant reductions in non-household demand, resulting in almost exactly the same amount of water being abstracted from the environment as the previous year. So, the environmental outcome was not affected and the output-focused performance commitment had significant potential to drive the wrong behaviours.

Equally importantly, asset health and resilience are also outputs and should therefore not have financial incentives attached to them. As with innovation, setting well-calibrated long-term incentives to deliver pure outcomes will, by their very nature, ensure that companies must look after their asset health and resilience. If they do not, the long-term incentives will bite, and significant expenditure will be required to get back on track with outcome delivery. This would be at the company's cost.

One of the further issues with incentivising asset health is the different approach taken to risk management within companies. For example, at Wessex Water, we built a grid that connected several of our small water treatment works together meaning that if one failed, our customers would still get water (the outcome). In practice, this means that we can run some assets to fail (including to end of life) and repair or replace them when labour is cheaper (i.e. after the weekend or after the night) because we had built a resilient system to manage our risk differently to other companies. In PR19, a financial ODI was introduced against unplanned outage of treatment works to reflect asset health. In our case, this provides a perverse incentive to repair or replace assets inefficiently (before end of life or at expensive times) to avoid financial penalties from the unplanned outage ODI. It is important that these perverse incentives do not occur in PR24. However, we support the sharing of unplanned outage data as part of sharing best practice – it may be that other companies could see our 'worse' performance on unplanned outage but our strong performance on supply interruptions and realise that they would benefit from a resilience approach like ours.

This continuation of reporting against most of the input and output metrics that we currently do is something that we support in all the above cases. This will enable the sharing of best practice and could provide a back-stop should companies begin failing to deliver the long-term outcomes.

It should also be noted that every company has a different starting point and different levels of shocks and stress to model in their resilience assessments and so it is difficult to apply a consistent target for everyone.

The aspiration should be to reduce complexity, with PCs that reflect the needs of customers, communities, and the environment. As set out in Section 4, we think these are:

- Great customer service
- Affordable bills
- An effective sewerage system
- Safe water supply
- Reliable water supply
- Sustainable abstraction
- Good environmental water quality
- Net zero carbon
- Increased biodiversity

We do not support the aggregation of PCs into a single value measure e.g. 'the environment'. There is a risk that this this would enable companies to trade-off between outcomes that should be of equal importance. These need to be considered holistically e.g. the impact of investment on water quality, carbon and biodiversity. If these are considered in a single metric, there would be the opportunity to trade one off against the other, resulting in missing targets that are important to customers.

We think there should be a 1:1 relationship between outcomes/PCs and the metrics used to assess these where possible, as shown below.

Outcome	**Metric**
Safe water supply	Water compliance risk index
Reliable water supply	Supply interruptions per property
An effective sewerage system	Sewer flooding
Great customer experience	C-MeX
Affordable bills	Proportion of customers with bills >5% of disposable income
Net zero carbon	Carbon dioxide equivalent emissions
Sustainable abstraction	Compliance with abstraction licences
Good environmental water quality	WFD – Nitrogen quantity
	WFD – Phosphate quantity
Increased biodiversity	Biodiversity score

In some cases, our current PCs are linked to delivery of specific outputs e.g. the Trym scheme. We agree that this should be a PCD rather than a PC under the framework proposed.

In the current regime, the disincentives and conflicts between common PCs need to be recognised. For example, the links between leakage and mains repairs.

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 think it is helpful to distinguish between monitoring of outcomes, outputs and inputs. PCs and PCDs provide a mechanism that could be used for this if these are defined in the right way.

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?

There are some measures that are incentivised by other regulators for example the number of complaints measured by CCW. Expectations on such measures do not need be duplicated as part of the price control.

The framework should encourage innovation and solution-based PCs should be avoided.

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

We believe your aim in setting performance commitment levels should be to find the most efficient five-year outcome delivery profile as part of a 25-year long-term strategy. This means that we should consider the holistic costs and benefits of our input/output options, using a robust appraisal methodology. Once this has taken place, it should guide a discussion as to the most appropriate blend of performance commitment levels across all the outcomes.

There are two key issues with setting performance commitment levels in relation to base expenditure:

1. Historical cost reporting is related to a prime function and does not consider secondary and tertiary benefits – we therefore expect there are significant unintended discrepancies between how companies report this information.
2. There is no industry-wide history of the holistic costs and benefits of solutions and so assessing the base costs against holistic performance levels will be extraordinarily difficult.

We agree with the principle of aligning performance commitment levels with the costs incurred by an efficient company. But, this is not practicable across the board and we would question the efficacy of such an approach in practice.

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?

In an ideal world, ODIs would be set as an integral part of the overall package of incentives. We believe they should have both short-term and long-term elements, perhaps best achieved through an RCV-based ODI.

Either way, it is important that the ODI scheme is set in a way that encourages appropriate levels of performance. A good overall incentive package should result in good-performing companies feeling positive about the prospect of outperformance and poor-performing companies feeling nervous about the negative incentives. This will ensure that the best combination of outcomes is delivered for customers, communities, and the environment.

The risk of the approaches set out in the document are that they lack teeth and therefore provide weak incentives for companies to improve performance. This area of the document feels slightly detached from the forward-looking nature of the remainder of the outcomes section, and very rooted in the PR19 approach.

Section 10: Cost assessment

Cost assessment needs to continue to evolve and improve to support the overall objectives of PR24. It needs to have a long-term focus on all wider social and environmental costs and benefits, not just the investment in the next five-year cycle. To this end, we do not think that it is appropriate to take the PR19 approach and iterate it. More fundamental changes will be required to comprehensively account for these new pressures.

We expect all this to be discussed in depth through the cost assessment working group to inform the final methodology. Our answers here are summaries of the discussions and representations we are making at this group.

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

Cost assessment at PR19, although a step change in quality from PR14, still had issues. It remains focused on money spent and not on true efficiency - we believe there are two key problems with the approach:

- Efficiency shouldn't just consider the upfront direct financial cost, but also the whole life cost, and wider social and environmental costs
- Efficiency is a function of how much it costs to do something and how many of that thing you do.

Currently the approach only considers the within-period direct financial cost and does not assess either of the elements outlined above to understand true efficiency. This can hide inefficiencies in both how much things cost and how many of the thing you do.

We need to be looking forwards to delivering the right long-term outcomes for customers, communities, and the environment. We should not be confined in cost assessment to only looking at the direct financial cost over the next five years.

The key priorities of cost assessment at PR24 should include factoring in other, non-financial costs, and understanding the true efficient cost of delivering the committed outcomes for customers.

Then it should focus allowances on what is required to be delivered. We think that this explicit linkage between allowances and delivery targets should supersede thinking in terms of base maintenance and enhancement; a split that although useful in understanding costs of input/output delivery, is holding us back in understanding the costs of delivering outcomes.

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

To assist in understanding the entire cost of projects, a lot more work can be done on whole life cost (WLC) and wider social and environmental cost benchmarking.

In addition, for activities that are standard across the industry, more unit cost benchmarking can be done to understand the efficient cost of delivery (but not the efficient level of activity).

Benchmarking outside the sector in the UK or to the water sector internationally, can provide a useful cross check, however, does pose problems. Other sectors will be unlikely to provide a direct comparison, even in overheads such as finance and IT as there are specific regulations and reporting requirements in the water industry (APR, DWPSs) that are unique.

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?

If the full costs of investments are considered, not just the direct financial costs, then this should naturally support the most efficient delivery of long-term ambitions.

In this approach we explicitly account for the costs of carbon, and the other environmental or societal costs, and companies can ensure that they are delivering these efficiently.

Most importantly, we need to understand the true cost of carbon. Significant work is being undertaken in this space by the Committee on Climate Change and the findings should be considered as part of PR24.

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

Currently, cost assessment looks at a five-year window of costs. Where solutions are less capital intensive, there may be ongoing costs that need to be considered. By considering WLCs as discussed over the last few questions these solutions can be accurately assessed for efficiency. Then the question moves to the certainty of funding this in future price controls.

We think that a good solution is making use of an RCV type construct where future costs can be guaranteed, and recovered through depreciation of this value, as proposed by United Utilities.

Equally, we support the use of markets to trade permits and credits in key environmental outcomes (carbon, biodiversity, phosphorus, nitrates). There are several catchment and nature-based solutions that would enable this kind of market trading. The clear benefits here are that the efficient price is exposed by the market. We will publish significant further detail on this idea in the coming months.

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

We feel that the link between cost and service is not well understood and will be incredibly hard to capture in many places while limiting thinking in terms of base maintenance and enhancement. We need to instead think about the fair and efficient costs of delivering the outcomes that customers and society wants.

Critically, we should not be looking at the costs of specific inputs, but rather companies should create plans that deliver these outcomes in the most efficient ways, using a range of methods and activities. By reducing the focus on the cost of input/output activities we should free up companies to innovate more, making investments that improve multiple areas.

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?

Ultimately, we think that costs need to be assessed and set at the level to deliver the outcomes set, and not limited to thinking about base maintenance / enhancement.

If we retain a base enhancement split, then comprehensive work needs to be undertaken to understand what costs are funded by base. Then, any desired improvements beyond this need to be funded.

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

We expect companies to need to be more resilient to more extremes in the future. We know that the future will not necessarily look like the past. The climate emergency will result in more extreme weather events placing more stress on the network and our catchments as systems.

This will mean that more will need to be done to ensure future operational resilience, and this should be factored into cost assessment. However, this should focus on ensuring cost assessment takes account of the future in a holistic way, rather than being backwards looking at specific individual elements of financial cost only.

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

While some of the current strategic planning frameworks do provide a basis for meeting long-term outcomes, others can restrict the ability to innovate and create clashes of incentives.

A key challenge is how to provide operational resilience while contributing to the net zero carbon target. Net zero carbon requires nature-based solutions which carry more risk in meeting individual output objectives but have a much better chance of achieving the wider societal objectives. Whereas, a traditional point solution for phosphorus or nitrate removal will provide greater guarantee of success but limit wider opportunities and work against the net zero carbon targets (operational and embodied). Some review of these planning frameworks to ensure they all align to the long-term outcomes of society would help make sure there are not conflicting drivers.

Also, the strategic planning frameworks would not encompass all the consequences of technology and innovation which require a recognition that the past costs are not a good indicator for the future. Examples include

- Where the change in technologies in operational technology has led to substantially less resilient and therefore much shorter-life assets that require frequent replacement. Often these changes are driven by outside factors and are not under our control and our whole cost base will increase.
- The replacement of human resource with technology is increasingly opening the sector to cyber risk, ransomware attacks, etc. From a resilience perspective, we all know we need to be increasingly vigilant and resilient but there is limited visibility of the scale and speed of improvements that will be required.

- As we increasingly implement more technological processes on sites, the complexity of the work arrangements is becoming such that a step change in resilience is required. This can be both in terms of health & safety and more widely the adoption of petrochemical industry levels of hazard assessment, maintenance regimes and processes.

Lastly, and of increasing significance, is the lack of resilience in the supply chain. This is an issue recognised by the government. Over the last few years we have seen a significant reduction in the resilience of much of the supply chain, with reducing production, fewer suppliers globally and in the UK for critical supplies. A very current example is the lack of HGV drivers, which is exacerbating this issue. These are both short-term and long-term resilience constraints which we can mitigate to some extent but not completely without a wider national resilience approach. The short-term impact is longer lead times and significant increases in price (30-50%) guaranteed for no more than six-month periods. The current cost assessment approach will be challenged by these factors and even the most efficient organisation is going to struggle to achieve year on year efficiency when combating such widespread and significant cost and time pressures.

All these aspects are live issues being assessed but not adequately incorporated within current cost assessment approaches.

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?

It is crucial that incentives for long-term resilience are set up and calibrated correctly. However, resilience should be measured by the ability to deliver the long-term outcomes for customers and society. This is true resilient service.

Being resilient is not working with fewer unplanned outages or sewer collapses if the long-term service customers receive is not affected.

To ensure a long-term focus we support more use of RCV incentives. This ensures a long-term liability, resulting in ongoing lower revenues and a lower market cap, until these issues are resolved. This also serves to place the risk of not delivering long-term resilience squarely on the shareholder, incentivising the correct investment to deliver resilient services to customers over both the short-term and the long-term.

With this focus, if the costs of delivering the long-term outcomes are understood, it reduces the need to assess specific resilience investment.

Section 11: Risk and return

The key measures of success in setting an appropriate balance of risk and return are affordability, service delivery, an improved environment, and the continued investment of private capital into the water sector. The latter point is encouraged by creating a stable long-term focused environment. Setting an appropriate WACC is fundamental to this, with financeability providing an important cross check.

However, we are clear that risk and return is about more than just WACC, and it is the overall balance of all incentives including true-ups, reconciliations, uncertainty mechanisms, ODIs, and financing that contribute to the risk and return package.

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?

Regulation has grown increasingly complex over the last 2 price reviews. More and more reconciliation mechanisms to share risk have been added. There is confusion between what incentives are for.

We think that simplification in this area will be of a benefit to both customers and companies.

We should be focused on delivering a small number of long-term outcomes, this should replace and simplify the large suite of confused bespoke ODIs that currently exist.

Moving to full CPIH indexation removes the need for RPI/CPIH wedge models.

If totex reconciliation is calibrated correctly, it alongside the service incentives will adequately incentivise innovation.

By creating a set of internally consistent, long-term focused incentives we think that the overall package can be greatly simplified. This will ensure that companies are incentivised to deliver long-term outcomes efficiently to the benefit of all stakeholders.

Any further complication moves us more to an overly complicated rate of return regulation, this is not a move that offers any long-term benefit to customers.

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?

RoRE could, with comprehensive guidance, be a useful comparison between companies. However, the main issue is the inter connectivity of the measures assessed. This will not necessarily be the same for each company which makes having a consistent, comparable approach challenging.

It does, however, provide a good cross check to where companies can potentially earn returns and to the magnitude they can earn in any given area. This can help calibrate incentives to ensure that companies returns are driven by delivering for customers and society.

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

Further to our point about the stability and long-term certainty of the sector, we think it is important that the CMA redeterminations are considered, specifically regarding the asymmetric risk in setting a WACC that is too low, and aligning financeability assessments to how they are undertaken by rating agencies.

Indexing the cost of equity is an added layer of complexity that we do not think is needed. It reduces certainty for investors and detracts from the long-term focused stable environment that investment in the sector currently offers.

In a world of greater uncertainty (particularly in sectors like energy), we could see that an index would provide benefits as it relates to uncertainty mechanisms. However, that is not the case in the water sector and so both the uncertainty mechanisms / reopeners, and the cost of equity index should be avoided.

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?

To ensure a stable long-term investment environment we need to ensure that efficiently raised debt is renumerated in the cost of debt calculation. Therefore, we think that consideration of balance sheet data is appropriate to set a cost of embedded debt.

The use of index data, we believe, would be challenging as each company's debt will have been raised at different times, so the choice of when to consider is another assumption being imposed in the notional structure that we expect would reduce accuracy and therefore value.

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

If there is compelling evidence that there is a fundamental difference in either the cost of debt or the cost of equity of a company then this should be reflected.

This should not only depend on size. If there is a fundamental shift in the cost of debt or equity for a company, driven by changing types of investment and the risks taken, that is in customers interests, then this should support an adjustment to the sector allowed returns at the time of determination. For example, whilst nature-based solutions might lead to increased inherent risk, there are many ways to mitigate this risk (better data, stronger ODIs, etc.). Depending on how the mitigation is set up, the return should reflect the residual risk.

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

Changing the notional structure to solve financeability should be considered with caution. It should not diverge from reality, with any changes being evidence based. It should incorporate the costs of making these changes.

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

This is another example where the consideration of specific incentives is a sign of regulatory failure in other areas. It is another example of trying to fix the symptoms of a perceived problem rather than trying to fix the cause.

The creation of properly calibrated long-term incentives should, de facto, incentivise long-term financial resilience and so we do not think more intervention here is required.

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?

We think that this is a natural continuation of the transition. By 2025, most of the RCV will already be linked to CPIH. CPIH is the designated national measure of inflation and complete transition to it will help in keeping the sector up to date and relevant. It also removes the complexity that the current blended inflation creates.

However, it is essential it is done in a value neutral way, and that it is accepted that it will create upward pressures on average customer bills (although it need not affect affordability in the truest sense of the outcome).

Section 12: Next steps for PR24

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

Please refer to our responses to previous questions around early clarity of the regulatory framework and the appropriateness or otherwise of the IAP stage.

Appendix

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

We do not believe that the costs and incentives for the existing water resources control should be targeted more effectively. We consider the water resources control in section 8.

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?

Whilst this would help from a modelling perspective, we maintain (as set out in section 8) that this is not the right answer and solves one symptom, without considering the cause.