Creating Tomorrow, Together.

Yorkshire Water's Response to Ofwat's PR24 Framework Consultation

Executive Summary

The next price review will take place at a critical point: the water industry's response to the climate crisis is well underway and will have reached the point at which the investment required to meet the innovation gap necessary to achieve net zero by 2030 will be clearer. There is also growing public demand for protecting and enhancing the environment, cleaning up rivers and minimising harmful overflow discharges.

The next National Infrastructure Assessment will also be well underway and is likely to emphasise the steps which need to be taken to ensure that the UK has resilient infrastructure.

In this context, Ofwat's recognition of the need for PR24 to plan for the longer term than is normally the case in a five-year cycle is most welcome and Yorkshire Water supports the good intentions behind this approach. However welcome these principles guiding the framework might be, they are as yet not sufficiently developed to fully understand what their implications might be in practice.

We will need to see more detail on how concepts such as 'whole life cost' and public value approaches will be incorporated or how Ofwat will bring much needed greater coherence to long term planning frameworks and achieve better alignment between economic and quality regulation.

Perhaps most significantly Ofwat has yet to show that its approach to risk and reward is appropriately balanced and there is little evidence in the framework document to reflect the comprehensive debate on this subject which took place during the CMA referral process. Without recognition of the need to make a fair balance between penalty and reward, this might mean that PR24 repeats the same downside skew of PR19 and disincentivises performance improvement and enhancement investment.

Ofwat's focus on ensuring that water companies have good financial resilience is understandable given the essential service they provide. However, the early proposals on gearing, cost of equity calculations and changes to financeability assessments do not demonstrate they are justified by the level of risk that is posed to customers. In

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most cases these risks are borne by shareholders with financial ring fences providing adequate protection to customers.

Finally, it is pleasing to see Ofwat recognise the need to simplify and streamline the regulatory process. This is in line with proposals set out in the National Infrastructure Strategy and also in the Penrose review. Careful management of the price review process and collaboration with other regulators will be needed for the benefits of these intents to be carried through into practice.

In conclusion, whilst we welcome the intention to take a longer term approach in the next price review, Ofwat risks undermining its own good intent until it shows how penalty and reward can be balanced more fairly and provides more detail to evidence its own good intentions.

Defra's Strategic Policy Statement (SPS) will be published just as the consultation on the framework document closes. Yorkshire Water's response to the SPS will consider whether what is set out in the framework document makes it more or less likely that the priorities in the SPS will be met. However, we know there are specific issues that need to be addressed - the time has come to deliver a step change in river quality and support investment required to solve complicated flooding issues and harmful discharges.

Our response considers the specific questions that Ofwat has asked in the sections of its consultation. We look forward to continuing to engage with Ofwat, the industry and wider stakeholders and working collaboratively to establish an approach to PR24 that addresses the pressures the industry and our communities face and ensures best practice through the application of insights taken from the PR19 lessons learnt review, the industry response to Covid-19 and from the conclusions of the CMA referral process.

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Response

2. Ambitions for PR24

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

The themes set out in the consultation are encouraging, recognising that the regulatory framework can no longer exclusively centre around the 5-year price review cycle and that the sector needs a wider vision and framework encompassing the value we deliver to customers and communities over the long-term.

The twin challenges of climate change and Covid-19 recovery will require the sector to evolve and find innovative solutions to ever increasingly complex problems. While PR19 focussed heavily on defining *what* companies needed to deliver – in terms of stretching performance targets with efficient costs – the emphasis for the future needs to be on *how* companies deliver truly sustainable solutions.

Service improvements cannot deliver value for customers if they come at the expense of increasing carbon uses or wider societal disruptions. Driving down bills in the short-term may alleviate immediate affordability concerns, but this cannot come at the price of storing up investment requirements for future generations.

The themes Ofwat has set out for PR24 are clearly important, however, the most vital questions are about the *interaction between* the themes. Unless companies have clear and strong signals about the priorities for investment in PR24, the risk is that trade-offs and decisions will be made that aren't balanced or optimal for all stakeholders

In the same way that the regulator's Statutory Duties have a clear hierarchy, we encourage Ofwat to consider a similar approach for the themes – either explicitly, or in terms of the strength of the incentives set around them for company delivery.

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An example of this is the way in which 'efficiency and innovation' is understood in context of 'environmental and social value'. As it currently stands, the regulatory approach only focuses on efficiency in terms of financial cost – companies are rewarded for doing activities cheaper than previously, irrespective of whether wider negative externalities exist. However, a clear understanding and definition of environmental and social value that quantifies the wider benefits (and costs) of activities would allow financial capital to be appraised on the same basis as other impacts.

As we have set out in a recent Future Ideas Lab on Capitals Based Incentives[1], we believe our analysis shows that a standardised approach to reporting wider value, using the Six Capitals approach, would unlock both Ofwat's and companies' ability to measure and articulate the wider impacts of activities. Several other companies in the sector also use this reporting framework, and as it is established by the International Integrated Reporting Council (IIRC) and used globally, would allow for greater transparency and comparability of regulatory impact.

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

The regulatory considerations highlighted in the consultation are important guiding principles, and we support the recognition that a simpler, clearer, and more locally relevant process is needed for PR24.

However, to give more long-term clarity to the regulatory framework, it is important that Ofwat continues to develop and share proposals for how it will connect price reviews into the future. There is wide support for the sentiment at the conceptual level, however currently there is limited information in the consultation document to understand what it might mean in practice.

For example, there are some key questions that arise out of the discussion of price reviews becoming longer-term:

[1] https://www.ofwat.gov.uk/wp-content/uploads/2021/07/Yorkshire-Water-submission-%E2%80%93-Capitals-based-incentives-Future-Ideas-Lab.pdf

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- On performance commitments, multi-AMP targets and trajectories seem sensible, but it's unclear if these will (or can be) binding beyond the 5-year period.
- For cost assessment, how will the current approach account for climate change impacts over time?
- How can the ODI framework appropriately incentives companies to adopt nature-based solutions in the delivery of outcomes?

These are not questions that should be left until the methodology design - these are fundamental changes to the current price review process and any proposals should be subject to an appropriate consultation stage and Regulatory Impact Assessment. The PR24 "Creating Tomorrow, Together" doesn't provide enough information to allow for meaningful comment in these areas, other than to set out that the issues are important.

Similarly, the principle of streamlining price reviews without losing the benefits of sophistication is a welcome consideration, however it's not clear how this will actually happen inPR24. For example:

- The proposals for introducing standardised or national customer research, if not delivered in time for companies' normal business planning process, could compromise the integrity of investment planning.
- The same issue exists for the early provision of key information – if key information points for company business planning are late or not fit for purpose, any benefits of streamlining will be significantly overshadowed.
- Introducing new categories of performance commitments, price control deliverables and key performance measures may reduce the number of financial incentives, but we must as an industry be sure that they do simplify or streamline the approach in a meaningful way.
- Equally for the cost assessment approach, there are few, if any, changes which are likely to streamline the approach or reduce regulatory complexity. The proposal for additional totex models, changes to price control boundaries and more granular enhancement models are likely to have an adverse Impact on simplification.

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It may be that some of these proposals effectively streamline the process from the regulator's perspective. However, the process needs to work for companies and stakeholders as well, and we would encourage Ofwat to include in the final decision document following this consultation, a clear articulation of where simplification occurs and if it is a regulator or company benefit. A Regulatory Impact Assessment would also help to clarify this point.

Simplification will also benefit the customer and improve Ofwat's public accountability. It is challenging for customers to understand the complexity of a price review and decide whether they are receiving a good deal or if the regulator has acted in their best interests over the longer term.

In terms of the third consideration - reflecting regional and national diversity in the price review, while maximising the benefits of comparability across companies – we have outlined our view in our response to section 6 about how this might actually work in practice in Yorkshire

We are a Yorkshire company and understanding of the regional priorities and insights is fundamental for creating and shaping a business plan that delivers for all our communities. While we can see benefits from moving to a standardised approach to customer research, particularly around enabling a common understanding of wider social and environmental valuations, this should complement and enhance the existing regional insights Similarly, consideration for how we should consider the direction and priorities from the newly devolved governments that prevail in Yorkshire. As it stands, the consultation does not provide any concrete proposals for how these various strands can be integrated and we would welcome further detail on this point.

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

We are pleased that Ofwat Is openly consulting on how to evaluate progress and success of the price review. For the credibility of the sector, it is important that Ofwat is able to demonstrate the value created by the price review process in an impartial and unbiased way. We therefore consider there is a role for an independent review process, conducted by a body external to Ofwat, possibly the Environment Food and Regional Affairs Select Committee, to ensure that the benefits of the price review are objectively assessed. This could also enable comparisons between regulatory approaches to be conducted and learning across sectors to be shared.

In terms of the potential methodology and metrics that could be used to measure impact, we would encourage Ofwat to consider the approach we have taken to quantifying "Our Contribution"[2] using the Six Capitals framework. Several other companies in the sector also use this reporting framework, and as it is established by the International Integrated Reporting Council (IIRC) and used globally, would allow for greater transparency and comparability of regulatory impact.

[2] https://www.yorkshirewater.com/media/022dl5eo/our-contribution-to-yorkshire-main-report-february-2021.pdf

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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?

As we have outlined in our executive summary, and response to Section 11, our analysis shows that the regulatory approach currently does not adequately take account of the interactions between the building blocks.

We see positive developments in some respects, such as the recognition of the relationship between efficient costs and performance delivery, however there is still a fundamental omission in terms of how the building blocks will be calibrated as a package – in terms of the "stretch" expected of companies and the strength of incentives. We encourage Ofwat to reflect on this, particularly in light of the general discussion of the issue in the CMA redeterminations for PR19, and we would welcome further detailed proposals for improvements in PR24.

In terms of how the PR24 framework can encourage the water sector to deliver wider value for customers, communities, and the environment, we have set out some proposals specifically for improvements to the performance commitment approach. We discuss this in more detail in the recently published paper on the 'Future Ideas Lab – Capitals Based ODIs'[3] We see a standardised approach to reporting using the Six Capitals framework as critical to understanding, quantifying, and incentivising the creation of value for the sector.

Fundamentally, the notion of value needs to be wider than just financial capital, and so we would encourage Ofwat to consider how each of the building blocks can unlock wider social and environmental value for customers,

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[3] https://www.ofwat.gov.uk/wp-content/uploads/2021/07/Yorkshire-Water-submission-%E2%80%93-Capitals-based-incentives-Future-Ideas-Lab.pdf

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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 agree with much of what Ofwat sets out in respect of a need for greater coordination and cooperation across the sector and beyond for the benefit of customers and the environment. We are encouraged by the narrative from government in support of the coordinated management of natural capital and have high expectations of the more integrated environmental work from Defra, the Environment Agency, Natural England, and other members of the Defra Group, including the new Office for Environmental Protection

We agree that water and wastewater companies operate complex systems, which function within an even more complex and diverse ecosystem when looking at the wide range of sectors and stakeholders both affecting and affected by our service outcomes. Greater collaboration and coordination are more necessary and more urgent than in previous decades. In our paper "PR24 and Beyond – 10 years of investment"[4] published on the Future Ideas Lab web pages, we explain at length the range and depth of collaboration, cooperation, and partnerships that we believe are essential for the challenges we collectively face.

Many collaboratives already exist in which we play central roles (including the Water Resources North group (WReN), the Yorkshire and Humber Climate Commission and the Yorkshire Land Network), whilst new ones will need to mobilise and become influential and impactful. This includes a more formal role for local government to shape our strategic plans, investments and service priorities, as set out in the National Infrastructure Strategy.

Of course, water companies plans should be well aligned with regional priorities which necessitates an ongoing and enduring cooperation beyond the stakeholder engagement of the price review process and which will help deliver greater levels of public accountability and transparency.

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4 https://www.ofwat.gov.uk/wp-content/uploads/2021/03/Yorkshire-Water-PR24-and-beyond-10-years-of-investment.pdf

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Fundamentally, many of the challenges we face from resilience and adaptation to a changing climate and protection of our environment, to water scarcity and quality under a growing population are not ours alone and they can only be dealt with in partnership with others from public bodies, regulators and NGOs, to organisations and partners in related sectors and participants in current and emergent markets - particularly agriculture. Many of those partnerships are in place and many need to evolve or develop.

In Yorkshire, we work in partnership with local authorities throughout the region to produce common strategies to adapt to climate change and to improve resilience. In our paper we stress how those partnerships will need to evolve beyond the point of collaboration and move towards sharing of assets, common strategic and integrated operational plans, and perhaps even combined workforces.

Although we do not go into detail to express the specific role of markets, we believe they will have a prominent place as one of a number of mechanisms for meeting some of the challenges outlined above. However, if we consider markets in their simplest form as how best buyers can be put together with sellers, this is missing the fundamental questions to be answered and does not represent a suitable justification in the cases of the key challenges we collectively face. Indeed, the environment is not a buyer; it needs advocates and supporters to act on its behalf and ones who cannot and will not trade away its priorities for self-interest or short-term political expediency. These parties must be our national and regional political guardians, our regulators, our sector working together, and our communities and those who represent their interests, who whilst taking the longer-term view, must act with focus and vigour now.

We note the proposals Ofwat outlines to evolve or adapt a number of the current markets and their associated frameworks either introduced at PR19 or earlier. We think there is greater potential to be gained from these markets for the benefit of customers and the environment, and we welcome Ofwat's acknowledgment that markets may provide alternatives to some degree to end of pipe solutions and the orthodoxy of approach. For example, working with other sectors, environmental services and solutions to address a range of pollutant sources before they enter the sewer networks.

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We are encouraged by our early work with developers and local authorities around planning for more sustainable developments, disconnection of surface water, adoption of Sustainable Drainage Solutions (SuDS)and attenuation solutions to better manage peak flows. We will continue our engagement with the aim of embedding a cooperative approach with greater coordination of activities and incentives to deploy more effective solutions in practice to improving the health of our rivers and reducing the harmful impacts of storm overflows. By way of example, we have shown in Hull how strategic partnerships can enable joint funding to develop common cause solutions for internal flooding

Such an approach will increase the range of solutions within a company's scope and be reflected in business plans. This greater complexity is likely to bring a level of uncertainty and the potential for divergence in companies' methods and their relative progress, influenced by the local priorities and distinctive nature of collaborative working.

This heterogeneous future could become challenging for Ofwat as it evaluates how companies should deliver outcomes for customers and the environment as there will not be a one-size-fits all approach – what is optimal in one region may not be optimal in another for a number of very valid reasons and choices influenced by the many interrelationships now widely recognised in the growing ecosystems in which we operate. Therefore, Ofwat needs a more flexible and negotiated approach to regulation based on a longer term assessment of business plans that will itself act as a catalyst to companies to explore and exploit alternative solutions for the benefit of customers, their communities and the environment.

We are very interested in the concept of a 'systems operator' (SO) coordinating market-based solutions at a large catchment level to manage supply and demand, flooding and drought and environmental protection for both water and wastewater. As part of PR19, we introduced a trial approach to a 'Natural Capital Operator' in three catchments as a reputational performance commitment. Although in the early stages of implementation, we would welcome the opportunity to share our insights on this approach with the wider sector and would be keen to engage with Ofwat and Government on what an effective SO model might look like. Creating a new 'market participant' role to take on the more challenging and often conflicting obligations of

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existing parties across the system risks simply passing the buck to a new organisation that is then somewhat destined to fail.

We welcome the decision to deprioritise the review of a bilateral raw water trading market. We concur with Ofwat that this market would be of limited value and interest presently. We also agree that the sector should take the initiative to determine where markets can deliver the best outcomes for their customers and then use them accordingly at the appropriate scale.

We believe the focus should be on bringing as many new sustainable solutions as possible to bear on the challenges we face and seek to maximise the range of beneficiaries and collaborators that can work with us in this aim, whether through markets or otherwise. We support the greater coordination across the sector through the regional water resource groups, water resource and drainage water planning frameworks and the WINEP taskforce.

We look forward to engaging with Ofwat's work on the case for greater coordination in the development of water resources infrastructure projects and how the legal and regulatory framework might develop and be implemented in an adaptive way.

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4. Increasing focus on the long term

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

The long-term challenges facing the sector and society are significant and we support of the need to allow a greater focus on companies' long-term planning within the price review framework.

We are not in steady state and the future will be different from the past, particularly in respect of the impacts of climate and ecological break down. This means that the current regulatory regime, founded in assessing the needs of the future based on the past, may no longer be appropriate. We recognise and support Ofwat's focus on ensuring that services are delivered efficiently. Increasing the assessment of that efficiency to consider long term planning beyond the five-year price review timeline would deliver significant benefits and ensure "best whole-life cost" is understood as well as "best in-period" cost. There is however, insufficient detail in the consultation as to how the cost assessment processes will alter to take account of this. We would welcome greater wider industry engagement on this point.

Focus on the long term will provide greater confidence that the price review process is addressing issues of intergenerational fairness. Greater clarity on the requirements of the future mean that there can be transparency on the sharing of risk and costs between current and future bill payers, as better recognition of long-term planning within the price review framework facilitates multi-AMP planning and delivery. This will support delivery of best value benefits for customers when coupled with increased certainty over the regulatory mechanisms that will apply in the future.

A revised approach provides an opportunity to adopt adaptive planning to address the uncertainty associated with the long-term. The requirement for longer-term planning means that scenarios can be developed and trigger points for action identified. This in turn will support the move to whole life best value decision making, as opposed to lowest in period cost decision making.

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A focus on the longer term will be beneficial for customers. The current approach of requiring significant in-period service improvements can result in least cost "in-period" options being selected rather than best value whole life decisions. A focus on the longer term would allow stretching service improvement targets over a longer period that would allow for best value whole life interventions to be delivered. This allows for customers and stakeholders to have improved visibility of how risks will be assessed and of potential response actions.

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

The context of a long-term strategy is to set out how an organisation intends to deliver its purpose now and in the future; how it intends to respond to identified threats and opportunities; and to set out a number of viable scenarios on which it's action plans will be based. It is likely that due to a broad range of factors companies' long-term plans will differ in scope and focus. Therefore, degrees of flexibility will be required to accommodate these differences and we would caution against reaching a position where a company has a long-term business plan and long term 'regulatory process business plan'.

A company's long-term business strategy is primarily to ensure plans are in place to meet its long-term objectives, and therefore could extend beyond the jurisdiction of the regulatory framework. The PR24 framework needs to be flexible enough to accommodate these plans, rather than requiring development of a prescribed 'alternative' long-term strategy.

As part of a well-established board led strategy review cycle, Yorkshire Water is in the process of updating its long-term business strategy. Since publication of our existing Strategic Direction Statement in 2018, there have been a number of significant changes at an international, national, and regional scale, for example Covid-19 pandemic, Brexit and continued regional devolution. Our long-term plans require testing, review and

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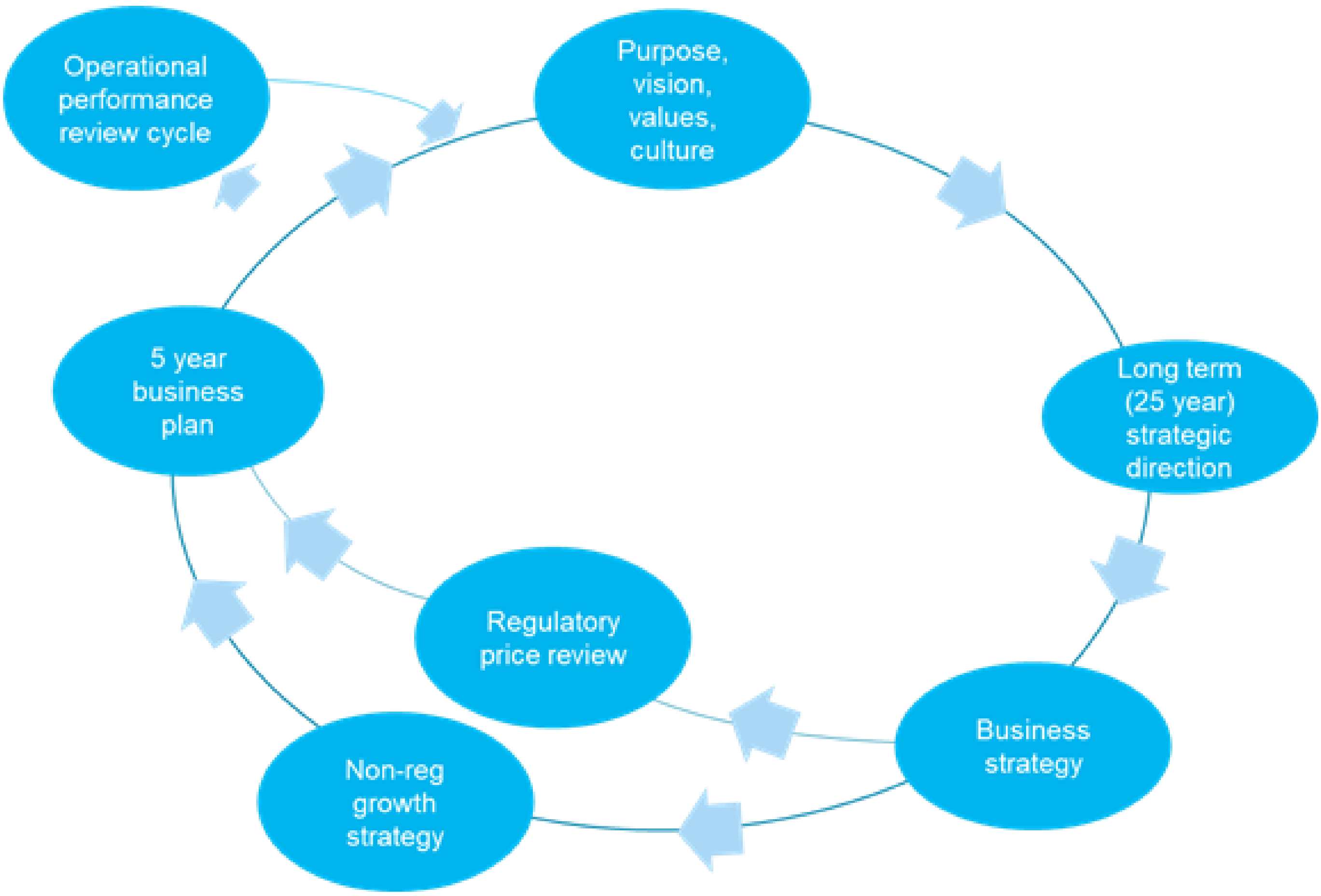
validation with our customers and stakeholders to ensure that they are reflective of the changing expectations and constraints resulting from such impacts.

Strategy Review Cycle



Our long-term business strategy is developed independently of the price review process, but delivery of the next five-year section informs our price review process. Whilst the business strategy will cover aspects beyond the regulatory price review process, the details that would be relevant for presentation in the price review process are:

- Risks and opportunities associated with the regulated service provision.
- Customer priorities.
- Stakeholder priorities.
- Identification of dependencies, for example as a result of the Regional Planning Framework for Water Resources or catchment scale environmental issues spanning company boundaries.
- Long-term service profiles.
- Uncertainty assessment and scenario planning – set principles for adaptive planning, including trigger points for significant interventions e.g. requirement for new water resources.
- Roadmaps – high-level interventions; costs and innovation requirements.

Common requirements are likely to help stakeholders understand each company's approach, but direct comparisons should be applied with caution. Companies have differing operational circumstances and therefore different risks to address, and their customers and stakeholders will have differing priorities. So, whilst common requirements may be beneficial, a comparative approach for the longer term may not be appropriate. Beyond relatively simple comparative measures such as long-term performance targets, common requirements may not reflect the complexity of individual companies approaches.

On page 18, the consultation states that 'to develop high-quality long-term strategies, companies need a level of clarity on how our regulatory framework will support that'. We don't agree that this is the case. There is no reason why a high-quality long-term strategy cannot be developed irrespective of and independently of the regulatory framework. The regulatory framework has limited impact on the assessment of risk and opportunities or the preferences of customers and stakeholders. Strategic ambition can also be set without reference to the regulatory framework. It is true that the regulatory framework may influence delivery of the strategy or the timeframe in which strategic objectives can be achieved but does not impact on the ability to develop high quality long-term strategies.

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

The outputs of the strategic planning frameworks are a fundamental part of the long-term strategy as they set out both an assessment of externalities and the impact of these on long term service risks, along with proposals for the most appropriate mitigating actions. The Strategic Planning Frameworks provide a feed into the long-term strategy which will consider issues beyond those in the Strategic Planning Frameworks.

Strategic Planning Frameworks do not cover all aspects of a water company's activities and therefore additional activity is required outside of these frameworks to develop both a long-term strategic review of requirements and a five-year business plan view. We comment on these points further in our response to question 7.1.

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

As our Strategy Review Cycle above shows a logical approach, although it should be noted that strategy has to be updated and reviewed on a regular basis - the long-term strategy set at PR24 will require review and adaption due to changes in externalities as well as changes in government and customer requirements. A plan is not static, and it should be expected that companies will review and adapt their long-term plans on a regular basis.

To deal with the uncertainty of the future, adaptive plans will be developed with 'no regrets' solutions adopted in the early years of the plan. In order to hold companies to account, there will be a requirement to demonstrate that these benefits have been sustained and this can be done as proposed in our Strategy Review Cycle. This is an area where partnership working can support decision-making around priority schemes and agreement to what constitutes a 'no regrets' solution. For example, in Hull, we are prioritising schemes through agreement with expert partners from two local authorities and the Environment Agency, minimising the risk that investment is not optimal. It may be the case that in order to mitigate risks or meet service targets in the future additional activity is required to maintain these benefits in the face of external pressures.

Future trigger or decision points should be highlighted, and the associated metrics reviewed. This plan will not be static and will evolve as externalities change. There is an ability to use trend analysis and estimations of future states, but it must be accepted that long-term plans will have to change.

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

As set out in our responses to Section 2 of the consultation, we are supportive of the overall principle to simplify the process. By providing early information on base costs, the service levels that base costs could provide, appropriate incentive rates and financing costs before business plans, it would enable companies to focus business planning on working out *how* best to deliver the requirements, rather than on determining the *what*. It would also enable companies to identify areas where a 'one size fits all' approach may not be appropriate and allow sufficient time to develop robust evidence bases to demonstrate where over or under delivery maybe required.

However, such changes need to create benefits for the regulator, companies and customers alike and must be provided in a timely way so as not to undermine the established business planning process. Therefore, we strongly recommend that early information should be provided as part of the Final Methodology proposals, to allow sufficient time for companies to use it in business planning. Any later will reduce any benefits that could form the provision of information and would risk compromising the ability of companies to plan appropriately.

However, by amending the price review process so that Ofwat becomes the central provider of information, it does place significantly more weight on the regulator to accurately identify comparative costs, service, incentive, and financing parameters without the benefit of companies' business plan information.

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

No response

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

We support the proposals to streamline the price review so that greater focus can be given to the longer term. As noted in the lesson learnt from PR19, companies found an 'early view' of certain information helped them in their planning. This early view or provision of more information on aspects of companies' plans would be developed to include both information for PR24 and a forecast range for PR29 and beyond. This forecast range could be refined each year as data is made available through the annual performance reports. We would support provision of the early information as listed in 4.2.1 for PR24 but believe a forecast could be provided for PR29, although it should be noted that companies can equally provide a forecast for themselves using the APR data on base costs.

Clarity in respect of the long-term regulatory framework is particularly important where discrete interventions span AMP periods. This is because where commitment will be made to expend future costs, there needs to be an understanding of how these costs will be treated in the next AMP period. If the longer-term regulatory framework sought to assess best whole life benefit as opposed to lowest in period cost and this approach was supported over the longer term, customers would ultimately receive better holistic value (as measured by the 6 capitals).

We would advocate the use of a standardised approach to assessing wider value, in line with the International Integrated Reporting Council's Six Capitals model. We have recently published 'Our Contribution' report and 'Future Ideas Lab – Capitals-

Based Incentives'[5] paper that outlines the benefits of using this as the industry standard for understating wider value.

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

The barriers to delivering greater environmental and social value through core functions were discussed in PR24 and Beyond – 10 years of investment[6].
Some of the key opportunities that were identified in that paper are discussed below. All of these aspects have been covered in parts of the consultation or this consultation response.

- More effective alignment between economic and quality regulators.

- Greater use of outcome regulation in the price review framework.

- Wider considerations of benefit and value to customers and the environment.
    - We would advocate the use of a standardised approach to assessing wider value, in line with the International Integrated Reporting Council's Six Capitals model. We have recently published 'Our Contribution'[7] report and a 'Future Ideas Lab – Capitals-Based Incentives'[8] paper that outlines the benefits of using this as the industry standard for understating wider value.

- Innovative funding approaches for delivering nature-based solutions, partnership initiatives and multi-AMP plans

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[5] https://www.ofwat.gov.uk/wp-content/uploads/2021/07/Yorkshire-Water-submission-%E2%80%93-Capitals-based-incentives-Future-Ideas-Lab.pdf
[6] https://www.ofwat.gov.uk/wp-content/uploads/2021/03/Yorkshire-Water-PR24-and-beyond-10-years-of-investment.pdf
[7] [7] https://www.yorkshirewater.com/media/022dl5eo/our-contribution-to-yorkshire-main-report-february-2021.pdf
[8] https://www.ofwat.gov.uk/wp-content/uploads/2021/07/Yorkshire-Water-submission-%E2%80%93-Capitals-based-incentives-Future-Ideas-Lab.pdf

    - See 10.4 for specific reference to the dis-incentivisation for nature-based solutions that arises from the requirement for opex which may not be recognised as a base cost requirement in the future periods.

- Greater recognition of the net zero challenge and the trade-offs between ecological benefit and carbon impact.
    - Welcome the recognition of the strategic importance of net-zero and agree that achieving net zero will have a fundamental impact on all aspects of operations, but will need to extend well beyond the company boundary to be achieved - as identified customer and supply chain and greater integration with the environmental systems in which we operate will be vital.

- A stronger voice for local customers and stakeholders.

- Recognition of the anchor institutions framework as used by other large regional organisations. Again, to provide a common framework for comparing companies and demonstrating alignment to local priorities

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

Yorkshire Water would welcome the opportunity to be involved in developing a proposal to understand what common requirements would help understand each company's approach.

We also note that not all companies will move on all aspects within the same timescales. For example, Company A's customers may prioritise leakage as they reside in a water scare region. Company B's customers may prioritise the reduction of flood risk as they reside in a flood prone region. Both companies may achieve the same comparative service position in respect of these measures by 2035, but it would be a better reflection of customer priorities if company A reduced leakage ahead of company B. A regulatory framework based on a long-term approach needs to be able to accommodate for this.

5. Strengthening incentives

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

While in principle the Initial Assessment of Business Plans (IAP) could deliver the benefits listed in the consultation (i.e. reduced regulatory burden and comparative industry information), in practice these are more evident for the regulator rather than companies.

The IAP requires substantial additional regulatory activity, and the short timescales for completion at PR19 created a significant burden on companies. In the 'Delivering Outcomes for Customers' section alone, the IAP resulted in over 60 required actions at PR19, which had to be either accepted or evidenced within the 6-week response period. The net impact of those actions was estimated to result in a c. -2 to 4% RoRE effect. Similarly, on cost assessment, the regulatory expectation was that a c.20% gap between company business plan costs and the regulatory assessment be addressed.

The short response periods between IAP, second submissions and DD were not sufficient to resolve issues of this scale, and it is not possible for companies to rework plans in any meaningful way to understand the scale of the impact. For PR19, we therefore saw little benefit in the IAP process, and only made minor changes between our original business plan submission and the IAP response.

Similarly, we had concerns over the scoring process applied at PR19 and the application of the business plan incentives. The 'Exceptional' category was not awarded as Ofwat considered that "no company's business plan was sufficiently ambitious, innovative and high quality to be awarded 'exceptional status' and receive higher financial rewards than 'fast-track' companies."9 Of the three companies who achieved 'Fast Track' status, either they did not submit plans meeting UQ costs or performance, or had weak track records in environmental performance.

[9] PR19 initial assessment of plans: Overview of company categorisation, Page 9

It was however notable that all three fast-track companies are the only listed companies in the sector and so would be the only companies likely to see direct positive or negative impacts from the assessment. This outcome potentially undermines the credibility of the assessment and generates mistrust from companies. While there is some transparency of the scoring assessments, there also needs to be some form of independent assurance that the assessments were applied consistently.

If the IAP remains a feature at PR24, then we would suggest that 'current performance' is of equal importance as any additional criteria on 'the long-term plans'. We believe this will avoid any incentive for companies to promise significant improvements in their plans, and make sure that companies are held accountable for their performance in the current period. We also consider that this should include reference to other Regulators performance assessments, such as the Environmental Performance Report (EPA) published annually by the Environment Agency (EA), and the Drinking Water Inspectorate (DWI) annual report. We also see a role for the Asset Management Maturity Assessment (AMMA) in any assessment of plans - we would suggest there should be a minimum gateway so that any company who does not score sufficiently well on the AMMA is unable to achieve higher levels of business plan incentives. This will provide confidence that companies are not being rewarded for promising 'jam tomorrow'.

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?

As we have outlined in our response to 5.1, a strong track record of delivery is a crucial aspect of the regulatory assessment. However, that performance needs to be evaluated against the regulatory context and standards set at the time. Companies can and should only be held to account against the regulatory determinations, otherwise there is a significant risk of retrospective regulation which undermines the regulatory requirement to operate in a clear, consistent, and predictable manner.

As we highlighted during PR19 and the CMA process, there are examples where performance commitment targets have been met historically (and therefore the company can demonstrate a strong track record of delivery), but changes in approach between price reviews can result in the company subsequently not performing well in comparative assessments in the next price review period. For Yorkshire Water, internal sewer flooding is a clear example of this.

It is also important that the timescales over which 'strong track record' in performance delivery assessment are assessed. We would be concerned if this only related to the available information in AMP7 as we do not consider that would provide a sufficient time period for a robust assessment to be made. Given the timetable set out for the price review process, Ofwat may only have access to three years of actual performance from the PR19 price review period (i.e. up to 2022-23). The potential risks of only considering this information are:

- **The atypical impact of Covid-19 in the early years of AMP7.** The full extent of the long-term impact of Covid-19 is yet to be realised, and therefore care must be taken in interpreting these years of company performance.

- **Distorted incentives.** If companies believe they will be assessed on the first three years of AMP performance, this could create an incentive for companies to hold of expenditure until year 3 of the AMP (i.e. 'back-loading') to appear efficient. As the CMA outlined, the full actual expenditure across the AMP should be considered.

Therefore, if a light touch approach is being proposed, we only support the principle if it covers a sufficient timeframe.

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 we have outlined in our response to 5.1, t the purported benefits of the IAP do not outweigh the significant regulatory burden it creates for companies. We are very supportive of the objective of streamlining the regulatory process, and so consider 'Option 1' in the consultation to offer the best opportunity to achieve this goal.

We would also encourage Ofwat to consider the cumulative impacts of the proposals for PR24, in particular the approach to providing early information on base costs, performance commitments, incentives and financial parameters.

Essentially, this creates an additional first step in the process, and should be recognised as such in the options outlined in section 5.2 of the consultation. The provision of this early information should provide companies with more certainty for the business plans, and both reduce the variability of business plan submissions and focus companies on Ofwat on areas where there are material gaps. As a result, we do not think the IAP stage will be necessary.

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

No Response

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?

As outlined in response to question 5.3, we see no merits to an extended IAP process, and so would prefer a streamlined draft determination approach. As highlighted in the consultation, the procedural benefits of early DDs are quite weak, and could actually result in additional uncertainty and complexity for companies.

We support the use of financial incentives to encourage companies to provide high quality business plans, but do not think these should extend to penalties. We are concerned that strong financial penalties on plans assessed as 'low quality' by Ofwat could provide very distorted incentives, and result in companies who submit plans that

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deviate from Ofwat's early view of base costs, performance commitments, incentives and financial parameters being penalised.

A good incentive should encourage companies to present their plan as they see it, and not just accept the regulatory view for fear of penalty. There are likely to be legitimate reasons why a company may deviate from the 'one size fits all' regulatory assessment, and it would not be appropriate for the regulatory processes to disincentivise companies from developing business plans that recognise that.

We are also concerned with the proposals to vary or amend business planning incentives throughout the process (i.e. between DDs and FDs) as this is likely to lead to weaker initial incentives on companies submitting high quality plans, as well as add in extra complexity and regulatory burden in the process.

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?

The main aim of the cost sharing mechanism should be to incentivise efficient expenditure without creating unintended adverse incentives over multiple AMPs.

The mechanism has been used by Ofwat at PR19 to try and mitigate a perceived asymmetry of information and to encourage companies to reveal 'true' costs within the business plan submissions.

We agree with the CMA findings that the intention of the cost sharing rates should be set to achieve the following principles [10]:

(a) Be sufficiently close to a symmetric cost-sharing rate to avoid creating a significant risk of perverse incentives, particularly over multiple periods.

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[10] CMA, 'Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations' March 2021, p. 606.

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(b) Maintain a distinction between the rates applied to fast and slow track companies, as part of the package of information revelation incentives applied in AMP7 [AMP8 for PR24]

(c) Avoid some of the potential distortions which result from the formulaic approach, particularly the theoretical incentive to under-bid in some areas of base and over-bid in some areas of enhancement; and

(d) Balance the need to set strong efficiency incentives with the need to appropriately mitigate the risks of over or under performance, some of which will be likely to relate to factors outside the companies' control.

The introduction at PR19 of different sharing rates for some categories of totex has moved towards addressing areas which are impacted by external factors which may not be completely within companies' control. And whilst this disaggregation of totex does add further complexity to the reconciliation, it does allow the aim of the mechanism to be achieved, as it weights the sharing of risk of performance between customers and companies.

We do not agree with any move towards including asset health monitoring into the cost sharing mechanism, as we consider that asset health should be monitored and addressed through the impact on PCs over the longer term. These should safeguard against the risks that companies may be achieving efficiencies at the expense of deteriorating asset health.

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

As we have outlined in our response to Section 9, and recent publication on the Future Ideas Lab – Capital Based Incentives[11], we believe the regulatory framework needs to move towards a 'value led' approach, rather than a 'service driven' one. This will help

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[11] https://www.ofwat.gov.uk/wp-content/uploads/2021/07/Yorkshire-Water-submission-%E2%80%93-Capitals-based-incentives-Future-Ideas-Lab.pdf

ensure that company activities and investments are directed to the areas of service that are the most beneficial to customers and wider society.

For example, reducing Per Capita Consumption (PCC) is primarily a 'means' of achieving wider goals such as balancing supply and demand and ensuring sustainable abstractions. It is not an 'end' in its own right. Setting targeted challenges based on this individual metric risks creating an undue focus on a specific activity, without understanding the reasons why it is required. It may well be that other means, such as reducing leakage, increasing water storage or abstractions provide more value in the specific regional circumstances of a company.

However, if a 'values-led' approach to incentives was to be adopted, it would allow companies to use PCC as one of a combined set of integrated measures to deliver benefit across multiple aspects of performance. Indeed, taking an integrated approach could mean that reducing PCC is a complementary means of achieving a reduction in discharges from the wastewater network, as less water will be in the system – as well as reduced energy use from lower pumping and treatment costs. We therefore think that setting targeted performance challenges in isolation from the wider context of company activities will potentially lead to uneconomic outcomes.

We are also concerned that targeted challenges could effectively introduce new quality obligations for companies outside of those required by the environmental and quality regulators. It is not clear how this would fit with the established strategic planning frameworks where the package of obligations for companies is determined.

Additionally, by setting the challenges within a specified timeframe, this removes companies' ability to identify and adopt the most cost-beneficial/effective approach over time. It may well be more efficient for delivery to be phased over a longer time period to allow the full potential of integration with other investments and trade-offs across the plan to be realised.

Similarly, targeted challenges could expose the industry to high profile, but transient, issues. Setting five-year challenging targets on the basis of topical subjects does not appear to compliment Ofwat's objectives to set PCs on "enduring outcomes" or with the themes of long-term planning and public value creation.

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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 welcome Ofwat reviewing the regulatory framework and range of incentive mechanisms that could encourage greater innovation across the sector for AMP8.

The PC and ODI regime and comparative cost assessments can encourage companies to pursue and discover more innovative approaches to achieve both better performance for customers and the environment and advance their cost efficiency. We also welcome the consistency and stability a longer term view of performance commitments with greater in-period flexibilities could give companies in planning for service improvements that involve a wider range of more innovative approaches where results and costs may be less certain, and where, companies may be open to take greater risks than in the past.

However, there is a potential argument that a regulatory model will struggle to suitably stimulate a transformative innovative culture or greater risk taking required to encourage the *"fresh thinking and real change"* needed to deliver better, more sustainable outcomes to the challenges we collectively face. As Ofwat itself observed in its 2019 consultation proposing the centralised innovation fund and competition, *"there may still be barriers to transformational innovation of the kind that is required to address the challenges the sector faces (including climate change, population growth, and changing customer expectations). This is because commercial benefits are sometimes perceived to be less clear or less likely to accrue within a single regulatory price review period."*

As we highlighted in our feedback at that time there are differing views and opinions on how innovation and competition work in unison or conflict in markets that are monopolistic in nature. Conventional thinking may suggest that in markets where price competition is strong, innovation competition will accelerate as companies increase innovative activities as the key tool to find further efficiencies or differentiate to compete, but this is an incomplete picture. There is research testing the Schumpeterian contention that market power has a positive effect on the intensity and breadth of innovation, which shows a stronger shift towards greater innovation competition when price competition weakens. Financial constraints and resources (a company's ability to innovate), and the industry growth rate (an incentive to innovate), are important mechanisms to consider when understanding the trade-offs between price competition and innovation growth.

In our price controlled regionally monopolistic sector with its market growth limitations (fixed territories) innovation competition is understandably weak. Therefore, the innovation fund is considered a welcome addition (as would have been specific ring-fenced funding for innovation at company level). However, when we attempt to compare our sector to competitive sectors in the UK, for example when looking at productivity gains, we should not consider the innovation fund investment as an 'additive' complementary mechanism or catalyst to drive innovation activity beyond the level of that achieved in those competitive sectors being used as comparators (irrespective of the relative market power of the actors within these sectors). Rather the centralised innovation investment could be considered to act as more of a 'compensation' for the restrictive effects on novel innovation investment and risk taking by companies of the price control regime within which we have long operated.

We therefore welcome Ofwat's proposals to keep the innovation fund and competition established at PR19 under review for PR24. We are however very concerned with the proposals to introduce an additional efficiency uplift for innovation driven productivity gains within the totex modelling from an assumed value derived from the deployments of solutions driven from the successful innovation fund projects. Ofgem has proposed such an efficiency uplift within RIIO-2 in relation to the centralised innovation funding the electricity and gas markets have had access to for over a decade, and this has been one of the key areas of challenge by appellants to the CMA with testimony that such an uplift is unjustified.

When we look at the beneficial outcomes from the Low Carbon Network Fund (LNCF) and the Network Innovation Competition (NIC) that followed it, there have been estimates produced of multiple factors of investment made as payback in the future, but we understand funds invested so far still outstrip the benefits delivered to date.

The innovation fund and competitions were rightly set up to invest in the exploration of innovative ideas that companies would otherwise not pursue within a regulatory period or under the regulatory framework due to their associated risks and uncertain or protracted value. The competition that makes awards from the fund is focused on innovation agendas formulated within the sector led Water Innovation Strategy.

The majority of these agendas face into very challenging areas and issues that are difficult and to date seem steadfastly impenetrable. For example: delivering resilient infrastructure systems; achieving net zero carbon; and taking a whole life approach to responsible consumption and production. We should not expect rapid and sizeable gains in cost efficiency against the current base from the projects set against these challenges.

We believe:

- it is far too early to be thinking about the scale and timing of potentially sustained and universally achievable benefits from innovations discovered or created by innovation fund sponsored projects. Many of the projects will be by their very nature challenging (they are projects that companies would otherwise not have tackled without the existence of the sizeable centralised customer investment); they are likely to have very uncertain benefits and long payback periods; they may also pay back in ways that will not deliver an efficiency against the current benchmark, rather they may mitigate to some degree an inefficiency in future enhancement costs yet to be determined; and,

- there is a significant risk that a standalone assumed 'innovation' efficiency factor would actually double count efficiencies achieved by companies who had either led or subsequently adopted successful innovations output from the fund/competition when they declare costs and performance in their business plans (inclusive of the effects of the successful innovations adopted).

- such an approach could unintentionally penalise companies who lead on innovations. Along with the lack of value from created intellectual property accruing to the companies that innovate, there is a risk that the proposals discourage the type and level of innovation Ofwat want

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and disincentivises companies from participating in the competition much beyond smaller pilots with limited down-side risk. The innovative company may not see any material first mover advantage over a fast follower and the challenges the fund and competition are trying to help address are too critical to risk being stifled. It is already common for the original innovators to often accrue a relatively modest proportion of the aggregate benefit associated with an innovation, whilst more substantial value is created for others that adopt or adapt the innovation, as well as for society at large.

- The application of an additional innovation efficiency challenge also risks blunting companies' incentives to invest in innovation outside the central fund and competitions.

This would not be an issue if the water industry is an innovative sector in general, however this is not the case, as outlined in Ofwat's rationale for an innovation fund for PR19.

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

We welcome Ofwat's reference in its PR24 framework consultation to companies working to ethical business principles (EBPs) and the themes of ethical business regulation (EBR) more widely. As an 'anchor' institution in the Yorkshire region we are in a unique group of organisations that can come together and work to provide public value greater than the sum of our parts. We serve our region with a wider purpose than defined in our licence and we operate to a number of principles and approaches that could be described as working to what are commonly considered EBPs. We see many other companies in our sector also employing EBP in practice in a range of ways relevant to their culture and their customers and stakeholders.

We would be pleased to explore EBR and EBP with Ofwat further and we believe a focus on the longer term outcomes for the benefit of current and future customers and communities should be a foundation of work to embed ethical business principles into the PR24 approach and methodology.

Yorkshire Water places great worth in being transparent and working collaboratively. We have now reached an 'open data by default' position, having articulated this ambition in our PR19 business plans, and we believe this has already markedly improve transparency and will lead to greater trust with our customers and the communities and partners we collaborate with.

We publish all our performance data on the Data Mill North platform covering a wide range of datasets[12]. We also publish our event duration monitoring data from combined storm overflows annually, our latest performance commitments data quarterly, and our water situation report each month. Unfortunately, we have not been able to hold any open data hackathons for the majority of this year due to our response to Covid-19, but we recently resumed our work by holding an open data hack focussing on pollution data.

We take action on a number of fronts beyond our core obligations and consider it our duty to understand and promote the use of a Six-capitals approach in monitoring, reporting and decision making so that human and social capital are assessed alongside financial and natural capitals

Yorkshire Water was an early signatory to the Natural Capital Commitment, which confirmed our commitment to working with partner organisations, and working with nature, to create better outcomes for the environment, and to get the most out of the land to ensure great service and great recreation opportunities for customers and visitors throughout the region. It also commits us to share the outcomes of our natural capital assessments publicly, helping other organisations to consider their own impacts and dependencies on natural capital.

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[12] datamillnorth.org/publisher/yorkshire-water

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?

Yorkshire Water is proud of the contributions we have made over the past two decades to the development of customer research techniques in the integration of business planning. From the first use of customer valuations in cost-benefit analysis in PR04, through to the most recent extension of that principle in the use of Six Capitals in investment optimisation, we have always been at the forefront of customer research development and innovation for the sector.

While we understand Ofwat’s proposals are intended to improve the comparability of customer research approaches, specifically for use in Outcome Delivery Incentives, we are concerned that the proposals could also have fundamental impact on the development of companies’ investment plans.

The use of customer research in ODI rates at PR14 and PR19 was a direct extension of the cost benefit approach already practised by the sector for business planning. The economic logic is straightforward – customer research provides an indication of the marginal value customer place on increments of service improvements/deteriorations, which is then compared to the marginal costs of that change in service level. In principle, this ensures that investments (and incentives) are only made if the value they deliver is more than the cost of delivery. There is a direct link between the basis on which companies carry out investment planning and the incentives around the delivery of that plan. Therefore, unless the marginal costs and benefits are aligned between planning and incentives, the economics will be flawed.

Any proposals to create a national approach for customer research – particularly for marginal valuations of service – needs to recognise that the outputs do not just inform the incentives, but also company investment plans. This has significant implications for the practicality of the proposals, as the research will need to be available for companies at an appropriate time in the planning period. For our own business planning programme, we will start to run cost benefit optimisations at least 18 months before the PR24 October 2023 submission, and would therefore need to have the results of any standardised or national research in line with this timescale – ideally no later than the Draft Methodology.

Similarly, company cost-benefit analysis is likely to use a wider range of customer valuations than any national research. By way of example, we would encourage Ofwat to consider how the national research can be translated for investment planning purposes – a clear example of this is for attributes like 'Supply Interruptions', where the regulatory measure is 'Customer Minutes Lost' (i.e. an average of all lengths of interruptions over the customer base). Obviously, this is not suitable for planning purposes, where detailed breakdown of the length of interruption is needed (i.e. <3hours, 3-6 hours, 6-12 hours etc etc) as different types of investment solutions are required and also doesn't not reflect the significant variation in customer detriment experienced over different interruption lengths. Usually a 'primary' stage of customer valuation research is conducted to elicit the 'anchor' values, with a second stage study then conducted to disaggregate the more detailed valuations for cost benefit analysis. It is crucial for companies to design these two studies together to ensure that full use of the information can be implemented in investment planning. Any national research will need to take account of how companies will need to conduct second stage surveys to translate the national values into the specific investment planning approaches (i.e. the attributes companies use in their 'Service Measure Frameworks' for cost benefit analysis) both in terms of design, and timing.

Aside from these significant practical implications of moving to a collaborative national or standardised approach to customer research, we are also concerned that there is insufficient clarity to understand the full scope of the proposals. Given Ofwat's intention to "rethink customer research", it would be helpful to see a comprehensive analysis of the risks and merits of the proposals for national or collaborative approaches, covering:

- Types of research, i.e. quantitative survey methods such as stated/revealed preference, acceptability testing, longer term priorities trade-offs etc, and qualitative approaches
- How the research is used, i.e. business planning, incentives, day to day etc
- Timescales for delivery.

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The discussion document published in December 2020 on customer research and the current consultation do not include a systematic options appraisal on the proposed policy changes. Given how fundamental this issue is for the price review (it is essentially the direct customer voice in company plans), and how successful the evolution of the research approaches have been to date, any changes in this area should de carefully considered.

We are also concerned that a fully national approach to customer research risks masking the priorities of individual communities; we know from our research with customers that opinions can differ from one town to the next depending on their circumstances. This detailed understanding influences business planning decisions, so any national research needs to deliver similar degrees of granularity and segmentation. It is important to remember that customer engagement is undertaken to meet the needs of the customers and citizens we serve. Engagement must be meaningful and provide clear actionable results. We believe our engagement activity delivered a PR19 business plan reflected the needs of our customers and citizens both now and in the longer term. We acknowledge that elements of future price review processes could be considered in the context of 'common concern', but we would expect to work with Ofwat and the industry to clearly identify what these areas of commonality are. It is important to remember that it is this engagement which provides our company Board with the confidence and assurance that our business plan genuinely reflects the needs of our region and the people who live here.

We would like to see a clear methodology for how regional insights gathered from the full range of research methods will be integrated with any national or standardised approaches. It is clearly not in customers interests to disregard these insights in the price review process, so it is vital that how regional and national research will be integrated and treated as complementary is a key part of the collaborative approach. We note that the recent Consumer Council for Water paper on triangulation considers these issues but does not provide a practical solution to how this can be achieved.

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

As outlined in response to question 6.1, we recommend that any proposal for collaborative approaches starts from practical principles about how and when information is needed in the price review process.

We note Ofwat has started to explore this issue as part of recent industry workshops, and we look forward to continuing to engage in these discussions. We are keen to share the benefit of our experience with Ofwat and the wider sector and welcome the opportunity to be involved in the national steering group and delivery groups.

For any engagement to be meaningful, it is essential to have all relevant parties involved and consulted. In the context of nationwide research, we would challenge the suggestion that one representative body would be able to fairly represent the views of all companies. As a minimum we would expect a selection of company representatives from both a regulatory and insight background.

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

We agree there is merit in considering how the benefits of negotiated settlement could inform the price review process, however we do not think that such an approach could be adopted in time for the PR24 processes on a large scale.

As outlined by recent discussion documents from Wessex Water and United Utilities, there could be scope to test the 'negotiated settlement process to agree small, specific aspects of the business plan. From experience at PR19, our Living With Water Partnership in Hull could have benefited from such an approach, particularly in relation to the 'match funding' element of our enhancement expenditure proposals.

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

We are pleased that Ofwat recognises that the Customer Challenge Groups have provided important challenge and assurance on company's business plans, although it is disappointing that the forums will no longer be recognised formally in the price review process.

We are however supportive of the flexible approach proposed to challenge and assurance of plans, with companies determining their own challenge and assurance solutions for customer engagement that meet its specific needs and ambitions. Given that this is likely to lead to a diverse range of approaches from companies, we expect Ofwat to set out clearly if and how it intends to benchmark companies' assurance processes.

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

We encourage Ofwat to clearly articulate how customer evidence will be assessed and used as part of the price review process. An industry 'best practice' framework would provide transparency as to what is expected from companies as a minimum, but also provide clarity on how Ofwat will use insights derived from company engagement in its assessment of business plans, something which we feel has been missing from previous price reviews.

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

The consultation does not provide any specific details about how the proposed customer engagement approach will take account of the different regulatory frameworks in England and Wales. We are unable to comment of this aspect until further, concrete details are available on Ofwat's approach

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?

Whilst the Strategic Planning Frameworks themselves operate in discrete aspects of the water cycle, the outputs have to be considered in respect of their impacts on the holistic water, nutrient and carbon cycles. For example, the quantity and quality of water in rivers and aquifers can be impacted by water company activities and mitigated by interventions identified in the WRMP, DWMP and WINEP. Consideration of the outputs at catchment scale is therefore relevant.

Coherent consideration of the outputs of the Strategic Planning Frameworks will be supported by the requirement to submit business plans in the context of increased focus on the long-term. The long-term plan will set out the outputs of the Strategic Planning Frameworks over multiple decades, facilitating coherent and effective articulation of the required interventions in the 2025-2030 period.

The growing number of Strategic Planning Frameworks has in some respects increased the complexity. The main issue is with the misalignment of the timescales associated with each of the frameworks as opposed to the actual 'contents' or output identified within each framework. Companies have always developed their business plans with a long-term view of water resource, environmental and resilience requirements. Notwithstanding this, the regulatory timetable for PR24 results in a number of specific risks resulting from little time afforded between the finalisation of the Flood Risk Management Plans (FRMP) and River Basin Management Plan (RBMP) and the developing Water Industry National Environment Programme (WINEP); finalisation of the WINEP and company business plans and finalisation of the Water Resource Management Planning (WRMP) and Regional Water Resource Plan and the company business plan.

Similar risks existed at PR19, with significant challenges arising in respect of WRMP. The PR19 methodology contained expectations of service levels that impacted on WRMPs, with the methodology appearing very late in the WRMP process after decisions had already been made. In proposals for engagement between regulators on page 70, Ofwat may wish to expand proposal to consider what regulator to regulator engagement prior to issue of FDs to identify how any proposed to changes to company business plans would impact on outputs of the Strategic Planning Frameworks.

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

We agree that it is important that Ofwat can have confidence that companies have fulfilled their statutory obligations. This is largely demonstrated through the strategic planning frameworks, including agreement of the Water Quality Plan with the Drinking Water Inspectorate and the associated statutory instruments that result. We work closely with the relevant regulators to ensure that all statutory requirements are met as part of the development of our strategic framework plans. It would be our view that assurance that statutory obligations have been met would be better as part of submissions rather than being confirmed after the event. Should Ofwat adjust any aspects of companies plans that result from a strategic planning framework, then this should be done in conjunction with the relevant regulators.

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?

The desire to involve stakeholders more in the production of business plans is welcome. It fits with the Government's stated aims in the National Infrastructure Strategy and aligns with the approach we have been setting up to involve the Yorkshire Leaders Board, Yorkshire All Party Parliamentary Groups and others in structured engagement in the business plan process.

Giving stakeholders a role on commenting on the way in which companies have carried out stakeholder engagement effectively is also a useful principle.

However, it is not clear whether the role of the challenge group is limited to assessing how well companies have engaged with customers and stakeholders. The wording suggests the panel may also have a role in assessing business plans and the risk is that a national challenge group convened by Ofwat may not fully take into account local and regional differences which will drive stakeholders to look for different outcomes than may be expected by a national panel. The impact of the panel will be heavily influenced by its membership and the remit it is given.

In addition to assessing whether companies have listened to customers and stakeholders we should also consider whether the challenge panel could provide a route to hold Ofwat to account for delivering the Government's priorities as set out in the SPS. We have previously highlighted that there is little accountability in the SPS and that Ofwat should be required to demonstrate how the price review process meets the objectives in the SPS. We have proposed that the EFRA Select Committee should play a role in this, but there could also be a role for a challenge panel in assessing how well the price review process is delivering against the SPS.

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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?

And;

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?

We consider the discussion points, options and indicative proposals in respect of the current markets within the regulatory framework represent in the main a positive evolution of current 'formal' mandated and monitored markets.

We believe Ofwat's proposals could improve the level of competition or reflect pseudo competition through incentives to improve performance, productivity and outcomes for customers at a comparative level. We look at each market in the value chain and provide feedback on the proposals based on initial views and principles of fair and open competition and their potential to improve the value for customers.

Water Resources:

Firstly, we welcome the deferral of any detailed work on the bilateral market for raw water trading. We have not seen any material appetite for this market from non-household retailers we have tried to engage with on this conceptual market.

The water bidding market (water trading, leakage management and demand management solutions) remains relatively immature, and we may yet see a progression of feasible tactical level water trading opportunities coming into consideration within companies' water resource management plans for resilience and lower cost alternatives to incumbent owned/managed raw water sources.

We do not believe the proposals to move key parts of the water network+ control into the water resources control, to effectively create a new 'sourcing of treated water' control will itself encourage greater levels of 'within area' competition from third parties for water resource trading. However, incumbent to incumbent 'into area' trades across borders could be aided by a 'treated' water control. Where these trades are from surface water catchments, they are most likely to be transferred as treated water to mitigate the significant risks associated with invasive non-native species common with such transfers.

The ongoing collaboration of companies through the water resources groups and RAPID coordinated work will continue to be the biggest catalyst to trading, and as a member of WReN we continue to investigate regional supply scheme options. As Ofwat notes, the expanded control could give the regulator a better platform to assess costs more equitably to identify opportunities for 'comparative competition' to discover further efficiency at the previous boundaries. We do not disagree with the intent behind this proposed change to the controls, but we will only be able to comment further once details are subsequently provided on the planned comparative cost modelling.

We also would welcome clarity on how this new control will be created whilst ensuring protections set out at PR19 to avoid unwarranted asset stranding are revisited and extended at PR24. Companies require clarity In respect of the treatment of legacy RCVs and how the RCV allocations may be revisited to include the right mix of assets under a newly defined boundary between a downsized water network+ control an expanded water resources control.

We welcome the review of water trading contractual arrangements prepared by RAPID and will review and feedback directly on this consultation.

We are investigating opportunities in AMP7 with selected customers for final effluent reuse and sub-potable water supplies, so we welcome any reassurance from Ofwat in respect of non-public water supply trades that customers benefits will not be disincentivised by the regulatory regime.
We of course continue to welcome enquires and bids from third parties who have abstraction rights and water to trade. We follow a fair and consistent process as per

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our published bid assessment framework to evaluate and consider such options alongside our own solutions. We do have concerns that Ofwat's comments that companies may be required to contribute to the development costs of third parties could be encourage more speculative and under-worked proposals to be put forward to companies.

We would be concerned if customers were funding third parties for technical assessments of water quality and resilience, or changes to abstraction licencing and the development of commercial frameworks. Companies could support third parties with information and expertise working collaboratively on water supply schemes with potential, but we believe funding or reimbursing a third party's costs may not be an efficient use of customers funds.

Developer Services:

We reviewed with interest the main options presented in the consultation and the evaluations within the review by CEPA. We believe the option to take a sizeable proportion of the costs and revenues from developer services activities outside the network plus price controls to be an improvement from the approach in PR19 and a preferable option compared to option 1 presented by CEPA, where all developer services revenues continue to be included within the Water Networks+ and Wastewater Networks+ controls, but improving the cost assessment and reconciliations.

We believe option 2 is preferable, where contestable developer services costs and revenues would be excluded from the network-plus price controls but may initially be subject to a capped regulated margin. Non-contestable work (and network reinforcement costs and associated infrastructure charge revenues) would remain within the scope of the Water Networks+ and Wastewater Networks+ controls. We believe it would be an essential requirement this split approach to revenues that income offsetting is indeed removed from the charging framework for new connections activities.

As we raised with Ofwat during the consultation of the PR19 methodology and how developer services should be regulated for AMP7, we believed the best approach is for all developer services costs and revenues to be outside the network plus controls and

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the single till. Activity levels are to a large degree outside the control of water companies given the significant externalities impacting the house-building market and it is very hard for companies to accurately predict and forecast new connection numbers across their respective regions.

Ofwat also struggled when it intervened for the PR19 FDs with its own new connections' predictions based on ONS reported data that did not relate to new house building forecasts or trends. The Developer Services Reconciliations Mechanism (DSRA) uncertainty mechanism should alleviate any risks of significant under recovery of developer services revenue allowances in AMP7 due to new connection volumes above Ofwat forecasts and the single till issue, but there could be some significant values recovered in AMP8 via this uncertainty mechanism.

We understand why Option 2 would require more prescriptive Developer Services cost allocation guidance to ensure that incumbents are allocating costs to Developer Services consistently and accurately. Although in the short term this may add to the regulatory burden, it will ensure more 'cost reflective' charges that provide better market price signals, and will safeguard the generality of customers from the risk of funding a proportion of services for developers and customers seeking new connections to incumbent's networks.

With the bulk of developer services onsite and off-site activities contestable, the remaining non-contestable activities will be of relatively low value (mainly around point of connection applications and provisions of key information and adoption procedures) or recovery of network reinforcement expenditures.

We would welcome Ofwat or CEPA evaluate the impact of also moving the non-contestable costs and revenues outside the single till and use appropriate backstop regulation to ensure customers are protected in the long run and any material incidence effects that occur over the transition from the AMP7 regime to the improved AMP8 regime are managed.

It is important to note that even where a service or activity is considered contestable, it is clear that the incumbent appointee continues to have legal duties to provide such services to those customers that require connections and do not wish to use

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participants from the wider market place. Incumbents must act as a minimum In the capacity of the ‘supplier of last resort’ for the full range of common new connections activities, and charge for these accordingly. For customers making a single connection or smaller house builders who are of limited commercial interest to self-lay providers, incumbents are likely to remain the de facto supplier of choice or 'first resort'.

Therefore, we understand why some form of backstop regulation may be required to act as a level of price and service protection for these smaller but numerous customers of developer services provision by incumbents. We are supportive of a fair yet flexible approach to such protection so that charges to customers remain reflective of the costs incurred, including recovery of fixed costs, overheads, and a suitable margin; the rates or margins for incumbents do not risk foreclosing the market to self-lay providers and new appointees; and that the generality of customers are also protected from the risk of any creeping cross-subsidisation.

We agree that developer services customers should continue to contribute to the costs of reinforcing incumbents’ networks to deal with growth as well as on as well as on-site connection costs in full. We also agree with Ofwat’s proposals to remove the balance of charges rule and the ability to offer income offsets from 2025, and we have provided feedback to the earlier consultation on the details of this charging policy change.

We note Ofwat may wish to conduct a more comprehensive ‘state of the market’ review, which may encompass collecting data on costs, revenues and information on market penetration of other participants (self-lay providers and new appointees). We urge Ofwat to consider the information it collects from ‘Small Companies’ that may assist such a market review, and that information from the 2021-22 and 2022-23 APR may provide enough granular information without recourse to a standalone detailed call for evidence/information from companies during this year or next year which could add significant regulatory burden.

Subject to the options taken forward by Ofwat into its PR24 methodology, we also believe the PR19 developer services uncertainty mechanism (the DSRA) will need reviewing or even removing should a ‘cost-plus’ approach be rolled out for AMP8 and infrastructure charges are reconciled back to actual network reinforcement expenditures over time.

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Bioresources

We have reviewed the proposals for the bioresources price control with great interest. We provide a detailed assessment and commentary to the market review by Jacobs, the options outlined and the preferred proposals within our response to the PR24 bioresources consultation.

We have no comments at this stage on the proposals for the Household Retail Price Control.

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

We support Ofwat's focus on the efficient procurement and delivery of major projects and the intention to continue with, and improve, the Direct Procurement for Customers (DPC) mechanism.

We agree that the establishment of a longer-term view of major projects aligning identification through the key enhancement programmes (WINEP, WRMP and DWMP) with the funding process will help give investors and providers a transparent view of opportunities in the DPC market.

We think the areas Ofwat is looking to make improvements on, or streamline and standardise processes, are comprehensive and will contribute to removing some of the potential blockers to DPC being an effective and efficient method to achieve outcomes for customers and the environment. The consistent application of Ofwat's future approaches to appropriately value social and environmental benefits into its view of 'best value' in relation to major projects for both DPC and in-house delivery is also welcome.

We would like Ofwat to reconsider whether it should lift the somewhat arbitrary exclusion of DPC for major bioresources projects. We believe there may be advantages

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from the wider use of markets in the bioresources control if third party providers and investors could benefit from the protections DPC can offer.

We would also be happy to work with Ofwat to identify appropriate incentives including allowing companies to retain a share of any outperformance from DPC contracts and mechanisms to mitigate conflicts of interest to allow incumbents to submit competing bids fairly.

We agree there is need to improve coverage of cost benchmarking models in relation to major projects and we would welcome discussion with Ofwat and the sector on how best to achieve this without creating excessive reporting burdens on companies.

As Ofwat acknowledges many new reconciliations were introduced at PR19 to ensure risks were appropriately allocated between customers and companies. We support Ofwat's stated aim to refine its approach making reconciliations as clear and simple as possible.

We agree that Ofwat should reviewing the balance of annual and end-of-period reconciliations and simplifying and standardising reconciliations where at all possible. We support the continued production of a 'reconciliation rulebook'.

We also agree any reconciliations that are superfluous should be dropped, for example the bilateral entry adjustment reconciliation.

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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 support Ofwat's intentions to modify and simplify this area of the price review and are pleased that the problems with the current approach for performance commitments are being recognised.

It is clear that the volume and complexity of PCs that companies are currently held to account for are unwieldy, confusing to customers and stakeholders, and may not incentivise the sector to behaviour in a way that is sustainable or desirable over the longer term. Any progress in streamlining and clarifying this for PR24 will be an improvement.

We agree that PCs should only be set in relation to core company services and should not be used to monitor delivery of statutory outputs or as reconciliation mechanisms for specific schemes. As part of the CMA process, a reconciliation PC was implemented for our 'Living With Water' partnership in Hull, as a pragmatic way to provide customer protection in a unique circumstance. We do not however anticipate that this form of PC will continue into the future.

We agree with the principle that performance targets and financial incentives should only be set for those areas where there is certainty that they will continue to be important into the longer term. However, the consultation does not provide enough information to understand what this might mean in practice.

The 'enduring outcomes' suggested in the consultation may appear sensible at a policy or theoretical level, but as the gradual evolution of the Outcomes framework to date demonstrates, lack of clarity about how the incentives interact with each other can lead to conflicting priorities, weak incentives or uneconomic outcomes.

While the enduring outcomes may not be mutually incompatible at this high level, there are obvious overlaps in how they relate to companies' activities. These overlaps

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need to be clearly identified and taken into account when targets and financial incentives are set.

Most obviously, the issue of asset health and operational resilience has direct consequences for customer facing services. The current performance commitments and incentives do not take account of this connection or provide a way of linking changes in asset health over time with the impact on customer services. In some cases, companies are faced with mutually exclusive targets – the issues with Mains Repairs and Leakage are well rehearsed – or in other cases, result in double jeopardy. A single event can result in multiple, cumulative impacts across financial incentives.

As we outline in response to questions 9.2 and 9.4, it is also not clear how Asset Heath measures may differ from PCDs, as they are primarily outputs and do not have a direct value attached to them in their own right. We are also unclear about how the recent Asset Management Maturity Assessments relates to Asset Health measures.

Similarly, the introduction of standardised targets for environmental outcomes such as carbon or greenhouse gasses, which are an absolute necessity given the climate emergency, will add a further layer of complexity to how targets and incentives interact together. For companies, the question will become “what’s the least cost way of delivering this service, at the lowest carbon impact?”.

Unless the targets and incentives are set as a package, with reference to each other, and taking account of the power of each of the components, there is a significant risk that the incentives won’t encourage the intended behaviour from companies. We would like to see clear analysis from Ofwat in the methodology that demonstrates that these interactions and overlaps have been appropriately considered. In turn, this will also help inform the risk and return assessments.

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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 agree that there should be a clearer distinction in the regulatory framework between performance measures that are incentivised as part of the price review, and those that are used for other purposes such as monitoring, reporting or stakeholder awareness. We think this is particularly appropriate for measures that cannot be directly linked to cost allowances, such as affordability and vulnerability measures.

However, the proposals to introduce Price Control Deliverables (PCDs) require further development, as it is not clear how the Ofgem approach could be applied for the water industry, particularly in relation to specifying PCDs in the licence.

It is also not clear what the scope of PCDs might be. For example, would PCDs only relate to WINEP schemes or be for all schemes or only those above a certain materiality? We would also require detail regarding how under or over delivery be treated at PR29 and clarity as to what t benefits a PCD approach would offer beyond the previous 'log up-log down' mechanisms.

We note that although the proposals will help clarify the different function and treatment of measures beyond those directly incentivised, it is unlikely to simplify or reduce the regulatory burden for companies. Monitoring PCDs or measures outside of the price control will still require the same audit, assurance and reporting activity as currently needed for the full suite of performance commitments. To some extent, the proposals could be seen as further complication, as new categories are introduced into the performance framework

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

We do not think any aspects of company performance that are not included in companies Instruments of Appointment or are directly linked to the cost allowances should be included in the price controls.

We also continue to advocate for issues directly outside of management control to be removed from performance expectations wherever possible.

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

We agree that PCs should be set with reference to what is achievable with the base cost allowance. Not only does this ensure that customers get what they pay for, but also that the performance expectations on companies are realistic, and the concepts of 'efficiency' and 'productivity' are coherently applied.

In terms of what the aim of performance targets should be, we think there is a fundamental question that needs to be addressed. The previous price reviews have taken an approach that prioritises service improvements and cost efficiency in the short term as the primary objective. Targets and incentives have therefore been set on that basis, and companies have responded. However, the case for moving to a regulatory framework that incentivises 'best value over the long term', rather than 'least cost in the short term' is compelling. We have set our views out on this issue in the recently published Ideas Lab Paper on Capitals Based Incentives[13].

Moving to a values-led approach, rather than the current service-driven method would offer greater opportunities to deliver wider benefits for the social and environmental good, and also ensure that the way in which companies undertake activities is aligned with the public interest.

On this basis, we think that performance commitments shouldn't be an end in themselves or be set independently and in isolation from one another. Instead, performance commitments should primarily be seen as regulatory backstop protection for customers, with value creation being the primary incentive driver. In this way, service improvements would still be achieved, but only where they deliver the best outcome or value for the individual company's circumstances.

We recognise this is a considerable conceptual shift from the approach adopted by the regulatory framework currently. However, we do believe that this will provide a more economic and powerful incentive, and improve the alignment between company, consumer shareholder and environmental interests.

We would also encourage Ofwat to consider the potential impacts that the previous regulatory incentive approaches may have had on the industry's activities. While it is still too early to identify any concrete trends from the PR19 price review, as only one year of actual performance has been observed, there is the potential that the short-term focus will affect expenditure patterns.

For example, in trying to achieve the 'step change' in performance required for PR19, companies may have prioritised investment solutions that deliver immediate impacts rather than more sustainable approaches over the longer term. While linking performance expectations to base costs is a positive step forward for the regulatory approach, further care is needed in analysing the links between the recent base cost expenditure and longer-term performance expectations.

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[13] https://www.ofwat.gov.uk/wp-content/uploads/2021/07/Yorkshire-Water-submission-%E2%80%93-Capitals-based-incentives-Future-Ideas-Lab.pdf

We also suggest that, if performance targets are set on a common benchmarked basis, then there needs to be a similar mechanism to that of 'Cost Adjustment Claims' in the totex assessment. Company operating circumstances vary significantly across the sector, and a 'one size fits all' approach is not suitable for all setting performance targets.

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

We support Ofwat's intention to improve the transparency and consistency in the approach to setting ODI rates and agree that incentives should be consistent and comparable across companies to ensure that customers are not subject to a 'postcode lottery'. However, the desire for consistency and a standardised approach should not overshadow benefits that other sources of information can provide on how customers value the services they receive.

A collaborative approach to researching customer preferences and valuations is best used in conjunction with outputs and insights from company-led qualitative and quantitative research. The former shouldn't be viewed as a substitute for the latter. A collaborative approach can provide a national picture of customer preferences: where they align and differ, by how much and if explored further, the drivers of these differences.

Using outputs only from this approach is not suitable for business planning or setting company ODIs as it will not capture nuances in the preferences of a company's customer base. 'Better estimates of benefits' may be achieved in different ways: econometric modelling specification, making use of customer contacts/feedback data, citizens' panels, re-examining PR14 and PR19 data, etc. As we outline in our responses in section 6, there is also a very real risk that by reducing the scope of companies' involvement in establishing methods to elicit values form customers, progress and innovation in this area will be severely limited.

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It is unlikely that there is a single approach that will necessarily lead to better estimates of benefits. Triangulating outputs from several sources to establish a central estimate is essential. Additionally, and as pointed out in the CCW paper on Triangulation (CCW, 2021), the process of triangulation should be iterative as 'the best estimate' could evolve as more information is gathered.

We do agree that customer valuations may not be the best source of information for all of the ODI rates, and that other approaches may also be needed. The consultation highlights the issue of asset health and the difficulties in getting reliable customer valuations due to the lack of direct service impact. While the straightforward answer might be to link these ODIs to efficient costs, we think there are conceptual issues with this approach.

Assuming that a sound analytical method can be found to identify the efficient costs of changes in asset health performance, as we outlined in Q9.1, the potential issues of overlaps and double jeopardy cannot be ignored. Given that the consultation concludes that the use of marginal costs is just "too difficult", it is unclear how these same issues could be overcome for cost-based incentives.

We are also concerned that the newly created distinction between PCs and PCDs becomes very unclear where some financial ODIs are set on a cost basis. If the value delivered/foregone for the performance measure cannot be accurately identified, then the measure should become an 'output' by definition, and therefore a PCD.

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10. Cost assessment

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

We have set out in the following responses to questions in section 10 the areas where we consider improvements to the cost assessment approach are necessary. However, we are keen to highlight three particular areas where we would like to see further development of the regulatory approach:

- **Improving the links between cost assessment and service expectations.** As we have emphasised throughout our response, we do not believe that the regulatory mechanisms should be considered in isolation of each other, and that the interlinkages and trade-offs between components need to be articulated clearly. We have recently commissioned a paper to explore this issue for publication on the Future Ideas Lab and look forward to sharing our findings with Ofwat.

- **Reporting guidelines and consistency.** There was a lot of debate, confusion and disagreement on reporting guidelines, data definitions and consistency across the industry (e.g. base versus enhancement) at PR19. We would like better clarity and consistency for PR24 of definitions, and clear links to the APR reporting guidelines.

- **Development of Whole Life Cost (WLC) approaches**. Recognising that what is cost effective in one five-year price review cycle might not be the most cost-beneficial approach over the longer term is vital for shifting the sector towards longer-term planning and delivery of greater value for customers. We would like to see development of a standardised whole-life-cost approach, particularly for enhancement expenditure. A move to national customer research, standardised valuation frameworks (through the Asset Management Planning Framework being developed through UKWIR) and wholesale adoption of Six-Capital reporting could all enable a greater understanding (and comparability) of WLCs.

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We are pleased that the Cost Assessment Outcomes Working Group has been established to investigate potential areas of improvement for cost assessment and look forward to continuing to contribute to the evolution of the approach.

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

While we welcome any proposals from Ofwat to improve the evidence base supporting the choice of benchmarks, we remain unconvinced that any direct costs comparisons external to the water sector is appropriate.

For example, the consultation suggests that there may be retail activities which are comparable in other sectors and that could provide benchmarks and cross checks for the water sector. While it may be the case that the activities are similar, we would encourage Ofwat to also make sure that the service levels achieved by other sectors are also comparable. It would clearly not be appropriate for sectors that deliver significantly lower customer satisfaction to be used as efficiency benchmarks for water.

In terms of wholesale activities, we do not consider there to be a wide scope for direct cost comparisons with other sectors. Even if specific activities can be isolated and compared to external sectors, it's not clear how these individual activity benchmarks could be applied in the base costs assessment without considerable disaggregation of activities. While super-disaggregated models can be useful at targeting specific cost drivers, they ignore the trade-offs in cost that exist across various parts of the value chain and so can only be taken so far.

We do think there is more scope for Ofwat to improve the consistency and confidence in the choice of econometric benchmarks. As was determined at the CMA, Ofwat's decision to increase the benchmark during PR19 from the Upper Quartile to the third and fourth ranked companies was not justified. In particular, the CMA was clear that the benchmark should be set based on model quality rather than to goal-seek. In turn, the measures of model quality should be based on quantifiable measures of uncertainty.

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We would therefore encourage Ofwat to set out in advance, and in detail, the analytical criterial for determining the econometric benchmark.

Similarly, we are pleased that Ofwat recognises some of the issues highlighted during the CMA appeals in relation to improvements in cost benchmarking for enhancement costs, and particularly for phosphorous removal, leakage, and metering. We also encourage Ofwat to consider how previous historical cost allowances for companies may affect their specific base requirements and service performance into the future – particularly for these three issues.

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?

We are pleased to see Ofwat recognises the need for substantive decarbonisation of water and wastewater services as a fundamental priority of the sector, and that the primary focus at PR24 should be on driving carbon emissions down, rather than offsetting them.

It is however striking that many of the statements made in the consultation around the potential cost impact of Net Zero are unsubstantiated. It may well be the case that some decarbonisation solutions do offer opportunities for increased environmental benefits at a lower cost. However, unless these statements are supported by a robust evidence base, they remain assertions and not an appropriate basis for determining regulatory cost assessment approaches.

In terms of the options proposed for moving towards Net Zero, we consider that a combination of all three outlined in the consultation would offer the most comprehensive regulatory approach. We support a strong regulatory driver for companies to quantify the net carbon impact of their base and enhancement plans as part of the price review, and for it to form part of the financial incentive's framework.

We have developed a tool to help us quantify such impacts. Our Decision-Making Framework (DMF) allows us to quantify, and consider, both the carbon impact of interventions and of service improvements in our cost benefit analysis. Elsewhere it allows us to understand the wider environmental and societal benefits of our plans through 'Six-Capitals' valuations.[14]

As we outlined in our responses in Section 9, we encourage Ofwat to make sure that the various incentives are aligned and considered as a total package to ensure that the incentive signals and power are appropriate.

We agree that companies should be able to present incremental carbon cost adjustment claims. However, these should not just be for where additional carbon adjustments can demonstrably deliver wider (and efficiently costed) benefits. It is likely that there are material examples where what is needed to achieve net zero is actually not cost-beneficial, and so greater costs than historically observed are required.

We also encourage Ofwat to consider if enhancement models can incorporate some form of whole-life-cost assessment, including wider benefit analysis. While we have reservations about moving to a standardised industry approach to gathering valuations to support ODI rates, it would allow for a common cost-benefit analysis to be developed.

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

The consultation discusses the recent United Utilities 'Future Ideas Lab' paper that suggests nature-based solutions (NBS) may be dis-incentivised as they generally require enhancement opex which may not be recognised as a base cost requirement in the future periods.

While we agree that this is an issue, the capex bias on enhancement expenditure is not just related to nature-based solutions. Some enhancement programmes can have large

[14] Yorkshire Water's Decision Making Framework https://www.youtube.com/watch?v=iZ6CixsmPSA

ongoing opex costs which will not be captured in base modelling. Our phosphorous removal programme from PR19 is an example of this issue, and despite the statutory nature of programme, the high opex costs are not accounted for in base allowances in the future.

Similarly, the inclusion of NBS in specific enhancement models can create a distorted view of achievable efficiencies. As the CMA determinations highlighted, this arose specifically in relation to phosphorous removal models where both the Water Framework Directive (WFD) and Urban Wastewater Treatment Directive (UWWTD) driver were included. While nature-based solutions can be used to address WFD requirements, they cannot for UUWTD requirements, which require more expensive and certain investment solutions. As a result, the CMA removed the large identifiable nature-based solutions from the historical costs (6 United Utilities catchment management schemes) and triangulated the models with ones that also included the schemes.

We agree that the modelling should take account of NBS and not create any bias against them in future periods – but this principle should hold for all types of required solutions, not just NBS. Equally the inclusion of NBS should also not create unrealistic benchmarks for statutory requirements that cannot use NBS approaches.

We would encourage Ofwat to improve data collection regarding the type of scheme being proposed (i,.e. nature based or not) against enhancement drivers, and the deliverables.

We support Ofwat's intention to take account of the wider costs and benefits in enhancement cost assessment. Although we have reservations about the way in which a national customer research approach could be implemented, it is a great opportunity to inform a standardised cost-benefit analysis.

We would advocate the use of a standardised approach to assessing wider value, in line with the International Integrated Reporting Council's Six Capitals model. We have recently published 'Our Contribution'[15] report and a 'Future Ideas Lab – Capitals-Based

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[15] [15] https://www.yorkshirewater.com/media/022dl5eo/our-contribution-to-yorkshire-main-report-february-2021.pdf

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Incentives'[16] paper that outlines the benefits of using this as the industry standard for understating wider value.

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

Clearly identifying the relationship between efficient expenditure and performance levels represents a significant step forward in the regulatory approach from PR19. We strongly encourage Ofwat to make sure that this relationship can be demonstrated through robust analytical techniques, and that the two elements of costs and performance are set directly in line with each other.

An obvious area where the links between costs and performance could be improved is the application of frontier and productivity shifts. As Ofwat states in the consultation "For PR24 we expect companies to continue to improve performance from base expenditure". As we have previously outlined, applying both an efficiency expectation on costs, and an improvement stretch on performance at the same time, creates a double count of expected productivity gains for companies. Careful calibration of these two factors would significantly improve the credibility of the regulatory approach to setting costs and performance at PR24.

We recognise this is a difficult area, and there are various analytical techniques that could be deployed. However, the analytical techniques will only be as reliable as the data available to inform them, so we would suggest that a key requirement for improving the evidence base is likely to be a more granular understanding of companies' activity-based costs.

We note that Ofwat is minded to exclude 'marginal costs' in ODI calculations, on the basis that they are "too difficult" to collect, whereas for Asset Health ODIs, Ofwat intends to use efficient cost-based incentives in line with the cost assessment models.

[16] https://www.ofwat.gov.uk/wp-content/uploads/2021/07/Yorkshire-Water-submission-%E2%80%93-Capitals-based-incentives-Future-Ideas-Lab.pdf

As highlighted during the CMA process, for some performance commitments, there are clear differences in costs between 'maintaining' a level of performance and the costs of moving from one service level to another. This is particularly relevant for measures that require large capital investment to make step changes (e.g. Non-infrastructure assets). Therefore, it is difficult to see how Ofwat can either improve the evidence base on the relationship between costs and performance, and enable cost based ODIs, without a good understanding of industry marginal costs for performance commitments.

As part of our approach to PR24, we have commissioned a Future Ideas Lab paper to explore the potential analytical approaches to identifying the relationship between costs and performance and will publish this work on the Future Ideas Lab in mid-August 2021. We would welcome further engagement and discussion with Ofwat in the area as part of the Cost Assessment Working Group.

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?

The three options outlined in the consultation for funding longer term performance improvements beyond the base allowance are not sufficiently developed to allow for meaningful comment at this stage. We look forward to the discussion paper signalled for later this year.

As outlined in response to 10.5, we intend to publish an ideas lab paper in mid-August exploring these issues.

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

We need to consider the conditions of today, are not reflective of the conditions of tomorrow, and any forward look is an estimate. Therefore, such things as climatic effects accelerating beyond known levels, need consideration in price control mechanisms and not continued assumptions that we are in steady state.

As the cost assessment approach incentives companies to adopt the 'least-cost' approach in the short term, there is potential that the costs of a 'best whole life' approach to operational and longer term resilience have not be included in the historical cost modelling data.

By way of example, the 'best-whole-life' cost for a water main over a 40yr discount period is to replace the asset, however to drive upper quartile service improvements in a given five year price review control period would likely drive a 'least cost' approach of relining to address bursts, and/or cleansing to address discolouration.

Whole-life cost analysis should play a greater role in the regulatory process, even where this may lead to high costs in the immediate price control lower WLC leading to a more resilient solutions for customer service in the future.

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

The Strategic Planning Frameworks included in the consultation cover a significant range of challenges currently faced by the water sector, however the list could better represent drinking water quality through the inclusion of Drinking Water Safety Plans. We also consider that wider external risks to resilience, such as Cyber Threats, Resilient infrastructure, Pandemics should also be included.

One of the biggest risks to operational resilience is the need for long term infrastructure replacement, and we would encourage Ofwat to set out how this will be considered in the price setting process. We would also like to see this issue become part of the National Infrastructure Commission assessment, as it poses a significant future challenge for the industry and has widespread impacts ranging from customer bills and other interdependent sectors.

YorkshireWater

Development of an agreed (National) infrastructure replacement rate, benchmarked against national and international observed rate, linked to average age of networks, and observed failure rates historically would provide a long term and certain plan for the sector to address long term resilience issues.

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?

We agree that a clear definition of resilience, and the appropriate associated expenditure is vital for improving the regulatory approach in this area. Having a clear understanding of how resilience relates to either base or enhancement expenditure categories will enable greater transparency and accuracy in the cost assessment process.

We also support the development and use of common planning assumptions and scenarios across the sector. Similarly, agreement on the use of primary data sources would also provide consistency and comparability (e.g. planning estimates).

YorkshireWater

11. Risk and return

Introduction

Allowed cost of capital ("WACC") and financeability are critical areas within any price review. Whilst determinations of both aspects involve detailed individual assessments of core elements, it is important to also then step back and consider the overall risk and return 'in the round' in conjunction with WACC, financeability and the other core areas of the price review, such as cost assessment and outcome incentives.

In light of this critical 'in the round' assessment, Yorkshire Water believes that when considering the responses to this consultation it will be important for Ofwat to consider their cumulative impact and not just focus on the responses to each question individually.

Specifically, on WACC, Yorkshire Water notes Ofwat's statement that it is intended "to fund efficient financing costs" and "to provide an allowance that is reasonable for the price review period". Yorkshire Water would draw attention to the CMA's fuller and more rounded view:

"........we estimate a cost of capital allowance that we believe appropriately balances our duties under the Water Industry Act 1991. The cost of capital used in a price control can have a material impact on the level of customer bills. Our aim is to provide a cost of capital allowance that ensures appropriate levels of investment within the sector without overcompensating investors at the expense of customers." 17

Within its consultation, Ofwat also makes very little reference to the CMA's extensive recent review of WACC (particularly the detailed review of the elements of cost of equity) and financeability. We hope the opportunity is taken to adopt appropriately the conclusions that were made by the CMA or to clarify its rationale for not considering them.

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[17] *para 9.6 p738, CMA final report Apr 2021*

It is critical that the conclusions of an independent arbiter such as the CMA are adopted to maintain confidence in the long-term financeability of the sector, otherwise costs for customers are likely to rise in the long-term as investors exit the sector. In addition, it would be a reasonable expectation given Ofwat's stated intention for future price reviews to be part of a long-term plan. [18]

The key conclusions from the CMA include:

- WACC is the primary factor in ensuring an efficient firm is financeable, which is achievable by setting WACC at a level properly reflecting the costs of debt and equity.

- The capital asset pricing model ("CAPM") remains the best approach to estimate the cost of equity, supported by a robust financeability assessment. Alternative potential cross-checks such as MAR analysis and broker estimates suffer from significant limitations which impact their reliability as a cross-check.

- When assessing the individual components of CAPM it is important to consider all of the relevant datasets, e.g.:
    - Total market return ("TMR") should consider both RPI and CPI datasets
    - Risk free rate ("RfR") assessment should include AAA corporate bonds
    - Beta assessments need to consider full range of available time periods
    - Embedded debt assessment should include all instruments

- In principle, it was acknowledged that higher gearing could increase financial risk (albeit noting that whole business securitisation structures allowing higher gearing incorporate significant additional protections), but there were more important factors other than gearing that affected financial resilience. Furthermore, it was noted there were several mitigating considerations or protections and that there was a range of relevant regulatory tools already

[18] *"....too often the sector seems to start afresh at a price review. We need to see the next five price reviews as incremental steps to deliver a 30 year plan."* David Black, Water Security Conference, 29 June 2021

available to Ofwat. It would be concerning if the regulatory direction provided by the CMA's detailed review was not incorporated into the assessment of responses to the request for mechanisms to incentivise financial resilience in a price control period[19].

Ofwat's identified modifications and questions for stakeholders present as a set of specific measures and data sources in line with the approach taken at PR19. This has the potential to erode confidence of capital providers to the sector if there has been no change to the overall balance of risk and return following the completion of the CMA's review and the publication of its final report.

Yorkshire Water believes that it is imperative that any changes are clearly supported by evidence and consistently applied across the whole of WACC and financeability.

Yorkshire Water provides its view on the six questions specifically requested by Ofwat below, together with additional comment on four other key issues that Yorkshire Water believes are relevant. As noted above it is important that Yorkshire Water's response is considered 'in the round' and specific responses are not considered individually.

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?

And:

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?

We support the re-evaluation of the risk allocation framework and are of the strong view that it needs to be considered at the same time as the development of the individual regulatory mechanisms and in totality. As we outline in subsequent

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[19] [19] CMA Final Report: 9.1198-1207 on p1044-46 and 9.1222 on p1050

responses in section 11, it is imperative that the overall regulatory package is considered 'in the round', rather than as a cumulative outcome of the individual elements.

It is striking that the consultation document does not include much, if any, discussion of how the regulatory mechanisms work together, and the overall effect of those risk mechanisms. As it stands, there is not at present clarity around 'how' Ofwat is thinking about ensuring there is a balanced package, nor is there therefore any discussion of the analytical tools / methods that would be used to ensure this.

Before considering the individual risk allocation and mechanisms, we therefore encourage Ofwat to set out an explicit definition and approach for how the totality of the PR24 package will be evaluated, and use this as the basis of undertaking a thorough assessment of risk at the package level – i.e. an in the round assessment.

In broad terms, an 'in the round' assessment of a price determination refers to a regulator looking at the *overall picture* and making sure the 'balance' is appropriate, rather than focusing on individual elements in isolation. It is important because there are likely trade-offs and interdependencies across individual elements; but also because the evidence relating to each individual part is uncertain. Without careful and transparent consideration of these interrelationships and uncertainties, there is a risk of Ofwat mis-calibrating the price control to the detriment of customers, the environment and companies. Similarly, the CMA in its recent redeterminations emphasised the importance of setting price controls 'in the round'.

Following from the above, and to help inform the discussion around the appropriate methodology for PR24, as a first step we have set out a proposed definition and framework. Specifically, we suggest that there are two main perspectives one can view an 'in the round' assessment through: (i) cross-sectionally; and (ii) inter-temporally.

Cross sectional

In the water industry, price determinations require the setting of multiple individual parameters, targets, and incentives; within six individual price control areas. In this context, an 'in the round' assessment at PR24 can be thought of as a consideration of whether, in totality (i.e. across all the individual parts) the regulatory determination is 'appropriate' or is a 'balanced package'.

The above turns on whether, when setting the price control, Ofwat considers the notional company to be financeable (at the appointee level), primarily over the five year price control period (and similarly, from the perspective of companies, the same consideration would arise when deciding whether to 'accept' said determination). It is helpful to anchor the definition to the financing duty, for two reasons:

- Firstly, the duty captures the previously mentions considerations of trade-offs; interdependencies; and uncertainty (i.e. under the duty, Ofwat should not 'over compensate' companies, by allowing more revenues than an efficient firm needs; but nor should it 'under compensate' them, to the point where they cannot earn a reasonable return or raise finance). That is to say, the duty is interpreted in terms of a 'notional firm', rather than a requirement to finance 'actual' firms per se.

- Secondly, whilst it is sometimes suggested that there is a 'tension' between the financing duty and Ofwat's other duties (notably the consumer duty), this is a misnomer. Customers' best interests are served by the financing duty being met and, similarly, if the duty is not met, customers will likely suffer. Put simply, the financing duty is, ultimately, all about striking the 'right' balance – which, by definition, is how customer interests are met.

When thinking about an 'in the round' assessment from a cross-sectional perspective, the following key issues ned to be considered:

- **Offsetting.** By this we mean, if a regulator chooses to set a certain target or parameter in a way that is intentionally 'challenging' or 'easy' (relative to what the evidence suggests is 'likely') one would need to 'offset' that decision elsewhere to ensure the overall package is balanced. In turn, this means high quality and transparent information is needed that allows one to understand 'how hard' or 'how easy' the various components of the price control are.

- **Trade-offs.** By this we mean that, the 'likely' (or efficient) value for each parameter / price control / building block assessed in isolation might be different from what an efficient firm could ever actually achieve, due to trade-offs. Therefore, to ensure the overall package is balanced, trade-offs must be taken into account.

The CEPA report on risk allocation explicitly addresses both of the above. For example, in relation to risk, it makes the point that Ofwat does not have to make each individual risk a 'fair bet'; but it must make sure the package as a whole is. This, therefore, goes to the need for 'offsetting actions' in the first bullet. In addition, the CEPA report talks extensively about cross correlations and interdependencies, which goes specifically to the possibility of trade-offs.

Inter-temporal

The second perspective is the inter-temporal one. Even if (from a company's perspective) a price control is 'financeable' (in totality) over a 5-year period, it might not be from a longer-term perspective. For example, if the settlement prevents or defers investments that result in: (i) future service quality being below the level customers desire; and / or (ii) adverse environmental impacts are higher than they would otherwise be. This might give rise to a concern that one is 'storing up' future price rises to address said issues, which the company could not be confident would occur, thus eroding financeability over the longer-term (relatedly, too much focus on the near term might result in higher costs in the longer-term, as discussed below, which also undermines financeability).

Key issues to consider through this lens would be:

- **The underlying scarcity value of water over time.** The economic price of water is fundamentally determined by its scarcity: demand and supply. These are, in a longer-run sense, largely outside of company or regulator control. Demand is mainly a function of population growth. Supply is a function of rainfall and weather patterns but, ultimately, is fixed in the long-run. So, it is essential to 'step back' and consider what must be happening to the true value of water over time, when considering whether a package is balanced 'in the round' inter-temporally.

- **Environmental externalities.** The supply and consumption of water can give rise to a number of wider environmental and social impacts. In an inter-temporal sense, the key consideration is that if these are not addressed / appropriately priced in the near term, <u>the 'future harm' may be greater</u>.
- **Trade-offs.** When one considers efficiency inter- temporally, a key concern must be whether, if one does not properly reflect changes in the underlying scarcity value of water when setting price controls, future prices end up being higher (and service quality lower) than it would otherwise have been. That is to say, if scarcity value is not reflected, one arrives at a point where a 'step change' up in price is needed and moreover, the price ends up higher because the pathway has not been managed efficiently over time.

Points of process

Ofwat is considering providing 'early views' on: (i) the cost of capital; (ii) base costs; (iii) common PCLs; and (iv) ODIs[20]. Whilst the provision of information earlier on does not, in and of itself, give rise to an 'in the round' assessment of the price control, it could be supportive of one. That is to say, by providing information sooner, companies and other stakeholders may be able to identify potential imbalances sooner; thus giving them more scope to engage with Ofwat and provide additional information and evidence, if appropriate and needed. So, from a process point of view, there may be some benefit to this. On the other hand, the 'in practice' effect depends on 'how' Ofwat determines these early views and whether they are embedded in an 'in the round' view in the first place. If they do not, then having early sight of them will not fundamentally affect the end result.

Notwithstanding the overall need to consider the regulatory package 'in the round', we have also considered the role of the individual risk mechanisms. Following the publication of the consultation document, Ofwat also released a paper written by CEPA to address the allocation of risk in the price review methodology. In the following

20 'PR24 and beyond: Creating tomorrow, together.' Ofwat (May 2021); page 25.

section, we set out our review of the CEPA report, structured around the sections and headings contained in the document. We firstly summarise and provide our commentary on 'Part A' of CEPA's report, focusing on the 'framework' they use to determine the approach to risk allocation. We then do similarly for 'Part B' of the report, which addresses reform options identified by CEPA and comments on those.

1. Part A of CEPA report: framework

1a. Conceptual framework for allocating risk

CEPA sets out a framework for determining an appropriate allocation of risk between affected stakeholders. The report notes that this has historically mainly been framed in terms of controllability (i.e. risk is allocated to the party most able to control that risk). CEPA note that this is about both the party best able to manage the: (i) probability of a risk arising; and (ii) impact of a risk. However, CEPA suggests the 'controllability' criterion is insufficient because: (a) risks are often shared; and (b) it ignores the wider costs and benefits associated with risk allocation.[21]

We note that there appears to be two things missing from CEPA's early framework discussion.

- The first is that the report does not discuss the fact that the totality of risk (which CEPA names 'the risk budget') can itself be affected by the regulatory design. For example, poorly designed or implemented regulation (particularly regulation that is not predictable or consistent in its application) can increase the totality of risk unnecessarily. Similarly, well designed regulation might reduce overall risk (or at least, keep it at its 'natural' level).
- The second is that CEPA does not really discuss / make clear just how closely aligned its cost – benefit approach is to the well-established concept of controllability. That is to say, if one allocates a risk that is controllable by a company to companies, then whilst there may be a 'cost' to customers, overall the risk budget may be lower absent that allocation and incentive power is stronger. Hence, the balance of costs and benefits, as described by CEPA, would naturally point to the principle of controllability in any case.

21 See page 20 of CEPA report.

1b. Overarching constraints

CEPA highlights that, in totality, there is only 'so much' risk to be allocated. The report also states that there is no 'single' right allocation, as long as the amount of risk allocated to companies is consummate with the return on offer. This is a non-contentious point, which we agree with.

More interestingly, CEPA then go on to discuss the 'fair bet' principle in the context of financeability.[22] CEPA explains: *"we define this with respect to expected outcomes: in order to recover its cost of capital in expectation, the ex-ante expectation of probability-weighted returns must accommodate recovery of all costs (including the cost of capital) on average, over time."*[23] This definition is well-established, and we agree with it. CEPA further states: *"there is no requirement for the allocation of each individual risk to be a 'fair bet'; rather this is a constraint on the overall package."*[24] This is an important point in the context of the need for an 'in the round' assessment of the PR24 price control. Specifically, we note:

- We agree that the overriding requirement is that the 'package as a whole' must be a fair bet – but this then means robust evidence and tools are needed to ensure that this is the case.
- In practice, the risk of any individual item in isolation not being a 'fair bet' is that 'offsetting factors' are needed elsewhere, and these need to be accurately measured.

CEPA makes the point that having asymmetries in some specific areas may be unavoidable or desirable. However, this does then mean countervailing offsets are needed elsewhere to ensure the package is balanced. As per our observations above, we agree with this in principle, but the concern is about the 'in practice' application.

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22 See page 23 of CEPA report.
23 See page 23 of CEPA report.
24 See page 23 of CEPA report.

1c. Measuring risk

CEPA frames the measurement of risk as a 'practical issue', and highlights both the importance of 'accuracy' in risk measurement and the 'presentational value' of any information shared. CEPA specifically comment: *"accuracy is the most important objective. An effective presentation of results based on inaccurate information does not have value in policy setting. A key consideration should be ensuring that any approach to measuring risk is as representative of future outcomes as is possible."*[25] We agree with this and consider it to be a main area of deficiency at PR19.

CEPA further highlight that thinking about risk measurement in terms of its likelihood and impact is too simplistic. It notes that: (i) risk is on a continuum, and so probability distributions are a better way to think about it; and (ii) risks are rarely independent, but might be both correlated with other risks, and have multiple impacts.[26] We agree with both of these points and again, consider the absence of such thinking / analysis to be a deficiency at PR19.

1d. CEPA's proposed framework

CEPA concludes Part A of its report by summarising its proposed conceptual framework for risk. Our main comments on this (some of which we have made above) are as follows:

- We are not persuaded by the wider costs and benefits perspective described by CEPA – and consider that this would rarely, if ever, contradict the principle of allocating risk based on controllability.
- There is insufficient discussion / thinking around how the regulatory design itself can increase or decrease risk.
- CEPA emphasises the need to prioritise incentives (risk allocation) based on driving 'company focus' on the most important outcomes. In doing so, CEPA notes that where there is uncertainty (insufficient information to robustly understand risk) some 'headroom' may need to be built in.[27] We generally agree

[25] See page 25 of CEPA report.
[26] See page 26 of CEPA report.
[27] See page 27 of CEPA report.

with the 'management focus' point, but the issue around uncertainty and Ofwat's ability to properly understand risk is understated in CEPA's report. From our point of view, having a reasonably robust measure of the risk in question, and management's impact on it, are basic prerequisites for any incentive to make sense. Where that evidence is absent, it is unlikely to be sensible to have an incentive at all.

- CEPA's criteria around the 'suitability of risk allocation mechanisms' and 'best practice principles' are non-contentious, and we would not disagree with them.
- We agree with CEPA's suggested criteria around risk measurement.

The framework however does appear to present an overly complicated picture. Instead, we think there are some simple questions that ought to guide the approach:

- How much value is associated with the risk in question? (how important is the issue to customers?). This determines whether it is even 'worth' agonising over the allocation of that risk.
- To what extent is the risk controllable by company management?
- Can an effective incentive mechanism be designed and implemented? In turn, this requires:
    - an appropriate performance / outcome metric;
    - a robust measure of risk for the item in question; and
    - a means of accurately measuring outturn performance.

2. Part B of CEPA report: options for regulatory design

The next part of the CEPA report evaluates the existing framework and then proposes options for reform, based on the framework identified in Part A. In doing so, CEPA identify a number of 'issues' it thinks may need to be addressed ('shallow dives'). In the following, we briefly summarise CEPA's assessment of each issue, then set out our thoughts on each.

2a. shallow dive issues and options for reform

Issue 1: Long v short term perspectives

CEPA highlight that certain outcomes are ill-suited to being incentivised over only 5 years. CEPA also highlights that long-term incentives do not always align to the 5-year regulatory cycle.[28] Focusing on 'asset health', CEPA identifies and considers the following options:

- long-term asset management planning;
- explicit asset health metrics;
- longer price controls;
- multi-period allowances / incentives; or
- conditional allowances.

Of these, CEPA ultimately concludes that longer-term targets are needed and advocates both longer-term asset management, coupled with longer-term incentives. CEPA suggests that to address the reduction in flexibility etc this would entail, there could be reconciliations / reopeners.[29]

CEPA's analysis is not fully developed enough to comment in detail. However, intuitively we would agree that asset health is well suited to a longer-term incentive. We disagree with CEPA, though, that additional reconciliation mechanisms would be needed. Again, this goes to a tension between: (i) a decision in the first instance that the measure is sufficiently controllable to make it well suited to being incentivised; and (ii) a belief that there must be limits placed around variation from target levels to prevent out or under performance being 'too large' (which then reduces the incentive power).

Issue 2: ODI regime (complexity and incentive properties)

CEPA highlights three concerns with the existing regime. Firstly, that the sheer number of ODIs means that management may not be focused on the most important outcomes to customers. Secondly, they have some concerns over the detailed

[28] See page 36 of CEPA report.
[29] See page 40 of CEPA report.

implementation of caps, collars, deadbands etc. Thirdly, the level of complexity itself is problematic.[30]

CEPA considers five options for reform:

- Incremental change only; small tweaks to the outcomes regimes.
- Reduce the number of bespoke PCs.
- Reduce the number of common / comparable PCs (in absolute terms)
- Group PCs into measures by i) theme (e.g. asset resilience), or ii) higher level outcomes (e.g. wholesale water, clean rivers).
- Balanced scorecard approach (similar to PR09); providing a weighted incentive metric built up on multiple individual inputs.

CEPA itself does not propose which of the above is preferable at this stage, but instead calls for a 'review' of the complexity of the ODI regime (in particular, to understand how effective it has been in influencing behaviours). We agree with this point, in so far as there hasn't been sufficient time for the PR19 ODI framework to be assessed in terms of effectiveness.

In our view, the appropriate approach to ODIs is one guided by the overarching questions we set out previously regarding 'whether' and 'when' any form of incentive makes sense. Intuitively, if these questions were applied, we would expect there to be far fewer ODIs, and for the outcomes regime to be significantly less complicated. We further think that the inherent trade-offs and interdependencies across outcomes is directionally supportive of a 'balanced scorecard' (or similar) approach. Such an approach would enable Ofwat to refocus companies' objectives at the 'Outcomes' level or in delivering wider value for customers, rather than on individual, often competing, service improvements.

Issue 3: Re-openers (backstop re-openers to the overall price control settlement)

CEPA suggest that the IDoK and SE mechanisms (which limit risk exposure to companies in relation to material changes in circumstances during a price control) are

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30 See page 41 of CEPA report.

now 'out of step' with the broader regulatory regime.[31] Amongst other things, CEPA highlights: (i) that the mechanisms assess opex and capex separately, in the context of a totex framework; (ii) that the materiality thresholds, coupled with the costs of exercising the mechanisms, make them disproportionate – particularly in the context of increased risk sharing mechanisms; (iii) there is an issue around company licenses allowing for discounting at the WACC, or the cost of debt; and (iv) the equivalence threshold varies by company.

CEPA considers the following reform options:

- Replacing the IDoK and SE;
- Updating the mechanisms;
- Broaden the scope of re-openers;
- Change the measure of the materiality threshold from revenue (to, say, RoRE); and
- Change the 'value' of the threshold.

Ultimately, CEPA does not reach any firm conclusions, but suggests the IDoK and SE should be retained. Rather than propose specific reforms, CEPA suggests these can be thought about as 'in the round' risk sharing / mitigation devices.

In our view, it seems unsatisfactory to retain mechanisms 'as is' that <u>have not been used</u>, even when circumstances have arisen that, historically, one might have expected to trigger their use (e.g. Beast from the East). Rather, if the issue is that there is duplication across other risk sharing mechanisms, these should be rationalised and / or the materiality thresholds for IDoKs and SEs adjusted accordingly. We agree with CEPA that investors and ratings agencies likely ascribe 'some' value to the mechanisms. This would, on the whole, suggest that changes to the scope and materiality limits should be considered.

31 See page 46 of CEPA report.

Issue 4: Reconciliation mechanisms

CEPA discusses whether the number of individual reconciliation mechanisms (there are now 21) are proportionate.[32] CEPA considers the following options for reform:

- Retain reconciliation mechanisms, but improve automation and streamline the process: a bottom-up assessment of mechanisms could improve and standardise the mechanisms themselves.
- Greater use of sharing mechanisms, without reconciliation mechanisms: remove full reconciliations and use sharing as a measure of 'rough justice' in a consistent way across the control – for example, with respect to real price effects on wage costs.
- Application of materiality thresholds to reconciliations: put in place a deadband such that companies would only trigger a reconciliation if they could evidence that an individual reconciliation payment on an individual mechanism (or the aggregate net payment across all mechanisms) was more than X% of revenue or RoRE.
- Greater role for annual updating through digital response: use more real time data by increasing the use of digital regulation to decrease the lag between the consequences of performance and any pay out or top up as well as automate some reconciliations, where appropriate.
- Removal of within period reconciliations - single reconciliation at end of period: the reconciliations could be done at the end of the price control only, with effects spread over the following price control period (unless requested/ initiated).
- Onus on companies to complete reconciliations, with targeted Ofwat review: Ofwat's burden could be reduced if the companies undertook reconciliations, with Ofwat providing critical checks on some but not all of the calculations (either itself or through a third party).

At this time, CEPA does not reach any strong conclusions regarding the best way forward. Rather, the report calls for: (a) the development of a framework / principles for determining when to use reconciliation mechanisms; (b) an assessment of the trade-

32 See page 50 of CEPA report.

offs between reducing forecasting error and complexity; and (c) simplifying the 'process' of reconciliations as much as possible.[33]

Our main reflection on the growth of reconciliation mechanisms is the characterisation of variation in actual versus expected outcomes (revenues / costs) etc) as being a 'windfall fain' or 'windfall loss'. This characterisation is sometimes inaccurate or, at least, partial. That is to say, fixed ex ante allowances (based on forecasts) contribute to the overall incentive power of the regulatory regime (to the extent that said item is, at least partially, within company management control). Therefore, to some degree, ex-post variation can be a reward for good performance, or a penalty for under-performance. There similarly seems to remain a lack of debate or understanding around the trade-offs between 'in-period' and 'end of period' reconciliations, with that latter generally having stronger incentive power. We are concerned by the repeated statements around 'volatility' being bad for customers in this context, as there is no clear basis for believing this to be the case.

Issue 5: Inflation risk

Firms receive real allowances from Ofwat, yet interest costs are incurred mainly in nominal form, creating a nominal / index-linked mismatch. CEPA suggests the present arrangement may not be efficient. The report considers three options: (i) retain existing approach; (ii) separation of nominal and inflation-linked allowances; and (iii) full switch to CPIH indexation.

CEPA currently suggests retaining the existing approach is preferable, as the 'mismatch' issue is not material enough to justify a significant change. CEPA further states that, were Ofwat to consider full CPIH indexation, it should assess the associated inflation risk and pay attention to the experience in energy networks.[34]

Overall, CEPA's report provides no analysis or evidence on this issue, and it is hard for us to comment in any detail. We do think that, based on a number of considerations, there is a non-trivial risk that outturn inflation in the UK is materially higher than recent experiences over the coming years. We therefore think that Ofwat should consider with

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33 See page 53 of CEPA report.
34 See page 55 of CEPA report.

care the implications, were this to occur, and ensure its approach can accommodate that possibility appropriately.

Issue 6: Gearing Outperformance Sharing Mechanism (GOSM)

CEPA note that the CMA did not make use of the GOSM, meaning that it is right for Ofwat to re-look at it for PR24. CEPA frame the issue as follows: *"the overarching question is whether the interests of customers, companies and society are aligned when it comes to corporate and financial structure choice."*[35] CEPA further notes that Ofwat now has more information and transparency around financial structures and risk.

CEPA outlines three options for PR24:

- Retain the GOSM.
- Restrict dividend payments.
- Change the relationship between gearing and the WACC in its method.

For now, CEPA suggest all three approaches, starting with an examination of the link between gearing, the WACC and consumer harm. Following this, CEPA suggest considering what other mechanisms exist that might mitigate consumer harm.

We think CEPA's proposals are deficient and ignore some of the most important aspects of the CMA's decision, which we have covered in further detail in our response to 11.7. It is reasonable to think the evidence now means it is appropriate to assume there is no risk to consumers and no realistic prospect of risk transfer occurring. Thus, there is no need for any action whatsoever. The relevant evidence has already been developed and put before the CMA, thus rendering CEPA's first proposed step entirely unnecessary.

Issue 7: Cost of Equity indexation

CEPA notes that variation in elements of the cost of equity (e.g. the risk free rate) are outside of company control. Hence, there is currently a disbenefit of this forecast error risk sitting with companies. In turn, this creates a case for indexing the cost of equity.

35 See page 56 of CEPA report.

CEPA does not make a firm recommendation on this issue, but simply encourages Ofwat to think about it further.

Our response to 11.3 covers in detail our considerations regarding the indexation of the cost of equity and notes that there does not appear to be any compelling justification to introduce such indexation in order to improve risk allocation.

Issue 8: Connections risk/ DSRA reconciliation

The Developer Services Revenue Adjustment Factor (DSRA) mechanism aims to give companies protection from 'new connection volume risk', which is external and non-controllable by companies. CEPA state, however, that the revenue allowance for the DSRA doesn't take into account 'who' does the connection work; and so 'over-compensates' companies when someone else does it, but may 'penalise' them when they do. CEPA suggest this may undermine incentives for companies to provide 'good' developer services offers over time.[36] CEPA also notes that the 'unit cost' rates used in the DSRA are problematic, because they reflect an average mix of work, rather than the costs associated with the actual connections companies are responsible for. CEPA is thus concerned the current mechanism might incentivise companies to: (i) prioritise work with a lower unit cost than the average; and / or (ii) outsource to NAVs more than is optimal.

A separate CEPA report discuses reform options in more detail. However, briefly, two options are set out:

- **Option 1. An evolution of the current regulatory approach**, where all developer services continue to be price control regulated, within the scope of the network plus price control. Targeted reforms could include: (i) variation to the assumed unit cost to reflect the mix of work; and / or (ii) changes to the volume driver metric.
- **Option 2. A more fundamental change in the approach to regulating developer services** at PR24 that would be more reliant on 'backstop' regulation of contestable developer services. This could include 'contestable' developer services being removed from the price control altogether.

36 See page 62 of CEPA report.

We do not have strong views on the above options outlined by CEPA. We can see some merit in descoping developer services from the price control; but in practice, it may be difficult to 'cleanly' define and identify the contestable elements for deregulation. In addition, the 'extent' of the harm caused by relying on 'average unit costs' and 'total connection numbers' would appear to be limited, in the wider context of the price control design. As such, the value upside to customers of more material reform may be limited.

Issue 9: Accuracy of measuring risk (including covariance)

CEPA summarises well known limitations with Ofwat's risk analysis and highlights options for reform at PR24.[37] The options set out range from just doing a 'better' job of qualitative risk analysis and the individual incentive level, right through to quantification of risk at an aggregate level, using correlation matrices.

In our view, the main issue at PR19 (and still the main issue now) is the lack of robust and transparent evidence from Ofwat as to the likely risk range (quantified) for each individual parameter / incentive. It is paramount that this is addressed for PR24 and that there is transparency around how Ofwat concludes its targets are 'appropriate' in this context. Doing a 'good job' of this alone, with robust quantified analysis, is a major undertaking and should be a top priority. The development of 'tools' (such as Monte Carlo models) is clearly also important. However, the benefit of sophisticated tools is zero, if the inputs used are unreliable. Hence, the development of models should be seen as secondary to the real problem, here. In addition, given the challenge of even robustly quantifying individual risk, we are sceptical as to the feasibility of developing correlation matrices. In the work we undertook to develop our ODI and wider Monte Carlo risk models for Yorkshire, we explored the possibility of building correlation matrices, but quickly reached the view that this would be 'over-engineered', given the challenges of establishing data that could be used to populate them.

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37 See page 66 of CEPA report.

Issue 10: Measurement and presentation of risk

CEPA highlights that at PR19, Ofwat use the Return on Regulated Equity (RoRE) as its main risk metric. CEPA say this captures the impact of risks, within certain predefined probability ranges (most obviously the P10 to P90). CEPA is concerned about both the 'accuracy' and 'presentation' of risk analysis previously.

With regard to the former, the report highlights two points:

- A lack of understanding of the probability distributions underlying each risk, and the potential for non-normal distributions. Relatedly, a lack of understanding / evidence of how risks correlate with each other.
- An assumption that risk is independent. Ofwat's approach effectively 'summed up' P10 and P90 risks in a very crude way. CEPA highlight that this fails to take into account cross-correlations between risk factors. In addition, we would note that, even if risks were independent, the 'total P10' risk is not the same as the sum of individual P10s, as the odds at being at the P10 on multiple dimensions simultaneously are not given by the sum of probabilities.

CEPA then address 'presentational' issues, where the report suggests moving towards a suite of charts ('flag charts') that show the 'fan' of risk factors over time for the price control as a whole.

We think that RoRE is a helpful measure of risk and that RoRE ranges can be presented in a more useful way than at PR19; primarily, in the form of 'fan charts' the show how individual risk factors 'build up' to give an overall range for company risk. The real issue, however, is the more material matter of 'how' said RoRE ranges are calculated in the first place. Here, we think the key points are as follows:

- There is nothing inherently 'wrong' with each individual company coming to its own view on 'risk ranges' for each parameter, and its own view as to: (i) how to model those; and (ii) how to present the results. Indeed, the whole concept of 'company ownership' of plans would make it 'odd' to depart from this. Further, any responsible Board would want to know a company's internal 'best view' of risk exposure and be free to communicate that as they see fit.

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- However, the above should not be conflated with the additional need to measure and compare company risk on a like-for-like basis. This would seem to compel Ofwat itself to have analysis and evidence, and risk modelling tools, such that it can measure risk consistently across companies. As noted above, the key point here is 'how' one defines an objective measure of risk. This should be Ofwat's responsibility, and it should come forward with proposals.

2b. Developing the PR24 Regulatory regime

At the end of the report, CEPA presents two reform options for PR24: (i) incremental change; and (ii) fundamental change. The table below summarises these and our comments are set out subsequently.

In our view, the 'fundamental change' option does not so much feel like a fundamental change but, rather, contains fairly essential reforms required to address serious shortcomings with the approach at PR19. Specifically, it is hard to see: significant reductions in ODI numbers; longer term performance commitments; a reduction in reconciliation mechanisms; and improved risk modelling as anything other than necessary (but not sufficient) changes.

In relation to risk modelling specifically, we remain concerned by the focus on the 'tools', rather than the input information necessary to understand risk. At PR19, Ofwat simply asserted its decisions were 'right'. If the same approach is adopted at PR24, then a more sophisticated Monte Carlo analysis will add nothing. The main missing piece is a transparent and objective weighting of evidence, so that Ofwat's decisions can be seen in proper context, and therefore the likelihood of (efficient) firms achieving them can be better appraised.

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

There does not appear to be any compelling justification to introduce indexation of the allowed return on equity in order to improve risk allocation. Indexation of the cost of equity is currently untested and would introduce further complexity to an already elaborate assessment of the allowed return, as illustrated by the hours of expert discussion and volumes of pages assigned to it during the CMA's recent review. On this basis, Yorkshire Water does not believe repeating a full, or partial, assessment of the cost of equity every year would be a proportionate use of time and resources, for both customers and investors.

Within its consultation, Ofwat also makes very little reference to the CMA's extensive recent review of cost of equity. It is surprising that this analysis has not been considered and Yorkshire Water believes the opportunity should be taken to incorporate the CMA's conclusions.

The current policy of fixed allowances for a five year AMP period also provides stability, by enabling companies to plan effectively, since a core element of their credit metrics is fixed. Indexation would introduce additional risk beyond a company's control that could affect the decisions taken by a company in an AMP and impact the long-term levels of service delivered to customers.

As Ofwat has noted within its framework for the future, long-term strategy is important, but it is also critical to ensure that this long-term view is applied to the investors within the sector. Investors have historically been drawn to the stable base returns within the water industry. Indexation will provide additional risk around the base return which will impact the overall financeability of the sector.

Yorkshire Water was supportive of the introduction in PR19 of indexation for the cost of new debt, however, this change does not automatically provide justification to index the cost of equity in order to be consistent. Indexing the cost of new debt was logical given regular debt issuance debt by water companies and the cost of new debt is a standalone measure that can easily be compared to a chosen index. In contrast, equity issuance is less frequent, and the cost of equity comprises a number of different measures, which are not influenced by companies.

When assessing the overall cost of equity, it is also critical that the total allowed return is assessed "in the round" against available cross-checks. The key cross-check advocated by the CMA was the financeability test as evidenced in its final report by:

"WACC is the primary factor in the redetermination ensuring that an efficient firm can finance its functions"[38]

and

"financeability analysis therefore provides a valuable cross-check on the point estimate for the cost of equity"[39]

Yorkshire Water strongly agrees with the CMA's position on financeability testing in relation to WACC and believes that if further indexation were to be introduced, then additional financeability testing would need to be undertaken each year.

In the consultation document, Ofwat refers specifically to the volatility in the risk-free rate ("RfR") as one reason for introducing indexation and Yorkshire Water notes that Ofgem already indexes this element of the return on equity. In contrast, CEPA's report for Ofgem concluded that there would not be benefits from indexing beta, given the volatility within beta estimates; therefore, Yorkshire Water considers that volatility alone does not provide suitable justification for introducing indexation of allowed return on equity.

The relatively mechanistic and historic calculation of RfR, using publicly available market and AAA-rated corporate bond data means this is a feasible consideration in theory, but Yorkshire Water does not believe adjusting only one element of the cost of equity would be in the best interest of customers or investors.

[38] CMA final report, p1116, para 10.72

[39] CMA final report, p1116, para 10.73(a)

Under the CAPM used to determine the cost of equity there are three core elements: the TMR, the RfR, and beta. Each of these three elements is calculated individually as part of any cost of equity assessment; however all three elements need to be considered together to result in a truly consistent overall cost of equity, which would not be possible if only one of the three elements was re-calculated, whilst the other two were not.

Only indexing one element of CAPM would lead to a disjointed cost of equity where the constituent elements would no longer be based on consistent data points; therefore in Yorkshire Water's view additional scrutiny would be required to 'validate' the revised cost of equity each year, which would add considerable additional complexity, with little potential benefit to customers or investors. For example, having to complete financeability testing every year would be a complex, time-consuming exercise.

Whilst Yorkshire Water does not agree with indexing either the whole, or an element, of the cost of equity, if Ofwat were to pursue such an option then Yorkshire Water believes that there would need to be an extensive consultation on how any such mechanism would operate truly in the long-term interests of customers.

In summary:

- Ofwat has not presented a compelling justification to index the cost of equity; either the whole, or any individual elements.

- Cost of equity indexation is unproven and would add considerable additional complexity and risk, whilst providing no obvious benefit to customers or investors.

- Ofwat's consultation makes very little reference to the CMA's extensive review of the elements of cost of equity. To ensure stability and promote long-term financeability it is critical that the CMA's conclusions are adopted at PR24.

Further comments on cost of equity cross-checks have been provided in the additional question section below.

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?

Yorkshire Water believes that a balance sheet approach is the optimal approach; however it is not clear from Ofwat's document which "balance sheet data" would be considered when setting the allowed cost of debt: i.e. will the data be assessed on a sector, individual company, or alternative hybrid basis and reflect all instruments?

Yorkshire Water's view continues to be that the cost of debt should be set to reflect its all-in-cost of financing associated with delivering services to customers. Therefore, the balance sheet approach should be based on individual company actual costs, as long as those costs have been raised efficiently, since the amount and timing of funding requirements will vary by company. This approach ensures customers pay the costs most closely associated with the services provided to them.

During its referral to the CMA, Yorkshire Water presented clear evidence that its historical debt had been raised cost efficiently, when taking account of issuance timing, amount, tenor, and ratings. Additional, enhanced reporting within APR's from the 2020/21 financial year (e.g. Table 4B) will provide significant detail on individual company debt portfolios, simplifying the assessment process required.

Although not clear within Ofwat's consultation, Yorkshire Water notes the CMA and Ofwat have previously used a sector based approach. Our concern with this approach is that it produces an arbitrary set of "winners and losers" based more on the different timing of debt issuance by companies, than true efficiency differences between them.

This misalignment of past financing decisions and investment profiles results in customers within certain regions paying higher bills than necessary. Yorkshire Water believes that interest costs are a core cost that should be considered individually, along with totex costs, pay-as-you-go rates and run-off rates to ensure that customers receive a fair bill based on a consistent assessment of all the costs incurred in providing the service to their region.

Arguments previously provided to support a sector basis, rather than an individual one, have tended to focus on the perceived incentive benefits of a sector-based approach.

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There has been no substantive evidence to support this view and any incentive benefit from a sector-based approach is significantly over-stated. In fact, under a sector average approach, total industry costs remain essentially the same under a sector, or individual company basis, it is purely the allocation of those costs by company that differs.

We believe there is ample incentive under an individual company basis for companies to seek to outperform their allowance during the AMP and again notes its evidence to the CMA on the efficiency of its own past debt raising.

In addition, classifying a company as a “winner” or “loser” through a sector based approach risks the introduction of perverse behaviour, not in customer’s best long-term interests, as companies seek to maintain their position as a “winner”, or seek to shift from being a “loser” by adopting higher risk financing strategies that enhance refinance risk and future interest rate risk, potentially increasing long-term costs for short-term gain, impacting inter-generational fairness for customers.

If a balance sheet approach is adopted, it is important that all forms of debt, including derivatives, are included. Companies manage financing risk through their entire portfolio of debt. Unpicking and excluding certain elements of a debt portfolio, as Ofwat has sought to do previously, breaks the matching principle resulting in a potential cost of debt that does not match the risk.

Whilst an index-based approach may appear to have some merits, it is dependent on the selection of indices, trailing periods and possible adjustments to reflect sector specific issuances in contrast to the index (e.g. EIB debt and floating rate debt) in order to align more appropriately to a cost of debt for a notional water company. Consequently, Yorkshire Water believes that index data should be used solely as a cross-check for the range of cost of debt.

It is critical that ‘tenor at issue’ data is used to determine the trailing average period of the index, rather than ‘weighted average maturity’ data, which is more commonly reported and understates the tenor of debt raised.

For example, the weighted average maturity of the sector at March 2020 was 13 years; however this equates to an average tenor at issue of c.26 years. When determining the trailing average period to use with any particular index this should be closer to the tenor at issue figure of 26 years, rather than the average maturity of 13 years.

When using an index-based approach as a cross-check, Yorkshire Water also believes that it is unnecessary to make any adjustments to the index for any perceived outperformance versus the index or "halo" impact. The CMA's detailed review of debt issued within the sector found no evidence of any "halo" impact, with variations to the index being due to either credit rating or tenor.

Notwithstanding our preference for an individual company approach, if a sector based actual approach was adopted then Yorkshire Water believes that it would be critical to adopt the precedents set by the CMA recently. The CMA conducted a detailed review of the sector's debt when forming its decisions and Yorkshire Water sees no reasons to deviate from any of these decisions.

In particular, when assessing the sector cost of debt the CMA:

- Adopted a balance sheet approach, cross-checked against index data, with both 15 year and 20 year trailing average datasets utilised. Evidence showed that sector embedded debt costs would not reduce materially across the 2020-25 period as existing debt matures; therefore 20 year trailing averages are likely to be more representative of sector debt at PR24.

- Included all forms of debt, including derivatives, which Ofwat have previously sought to exclude. Derivatives are a legitimate form of debt, used by a number of companies in the sector and there has been no evidence to support their exclusion. It would be wrong to seek to exclude instruments on the basis that they are retrospectively considered 'expensive' in today's markets when they were executed efficiently when markets were considerably higher.

- Included all WaSC's and large WoC's to ensure the broadest and most appropriate dataset is used to determine the allowed cost of debt. The use of a limited dataset (e.g. comprising only companies with gearing close to the notional level) appears fundamentally flawed since it fails to recognise that all companies within the sector have legitimate reasons for variations in their cost of debt and it is unfair to penalise them based on arbitrary selection factors. This would also reflect that Ofwat regulates companies with a number of different financing arrangements.

It is also important to ensure consistency with question 5 below. If small WoC's are not allowed a premium to their cost of debt, then they should also be included within the sector dataset.

- Used a median of the sector data, rather than a simple or weighted average. Variations in company cost of debts are primarily due to factors such as timing of issuance and fixed rate versus floating rate, rather than other factors such as efficiency or gearing. On this basis it is important that each company within the sector is treated equally and undue weight is not applied to certain companies, or outliers. On this basis the historical precedent has been for the median to be the best measure.

Finally, Yorkshire Water also notes that Ofwat's suggestion of using a single index-based cost of debt allowance would not be consistent with a balance sheet data approach.

In summary:

- Yorkshire Water believes that a balance sheet approach should be the primary measure for setting the allowed cost of embedded debt for a notional company, with appropriate index data being used as a cross-check
- The balance sheet approach should be applied on an individual company basis, similar to totex, rather than a sector average.

- If a sector-based balance sheet approach is adopted, then:
  - All direct costs of financing are included to take account of the varying financing arrangements used across the sector

- All WaSC's and large WoC's included to provide the most representative dataset
- Median is used as the averaging method to remove the distortion of outliers
- A clear methodology should be agreed in advance, with transparent calculations provided throughout the process to support the assessment of embedded debt

- Index data used as a cross-check should utilise trailing average periods that reflect the tenor at issue appropriate for a notional WaSC/WoC and consistent with the sector currently, with possible adjustments only being considered following full analysis of variations to sector costs.

Further comments on the cost of debt, including the proportion of new debt and a potential combined allowance, have been provided in [the additional question section] below.

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

We believe that the smaller WoC's are best placed to comment on how any potential adjustment in relation to size alone should be assessed.

Yorkshire Water does not believe that size is a sole factor in the variations in the cost of debt between the companies within the sector. As detailed in Question 11.4 above, these variations are also due to issuance timing, tenor, and ratings as well as each company's risk position related to fixed versus floating rate debt.

Notwithstanding the above, Yorkshire Water acknowledges that as a result of their size, the smaller WoC's are unable to raise debt as efficiently as the other companies within the sector; therefore an evidence based adjustment would be appropriate, as provided historically.

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Yorkshire Water also notes that 'company size' might not be the most appropriate measure to consider. Smaller companies typically have a higher cost of debt due to the frequency with which they raise debt, and their inability to issue a benchmark bond in size, rather than the actual cost of that debt.

For example, some companies may only have one major debt issuance, that was raised on a long tenor prior to the financial crash; hence they have been unable to benefit from the subsequent fall in market rates that other companies, with multiple debt issuances have benefitted from.

We believe some consideration needs to be given to an adjustment that reflects the higher costs incurred by some companies as a result of specific timing issues beyond their control.

As noted above, to ensure consistency, if a company is not deemed worthy of a small company adjustment then it is important that the company is included within the sector dataset used to assess any balance sheet-based cost of debt assessment.

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

Yorkshire Water does not see any justification for changing the notional structure from PR19 and any changes must have a clear rationale for supporting customer interests, be substantively evidenced and consistently applied. Any possible changes for PR24 and beyond should be clearly signposted and extensively consulted on well in advance of draft and final determinations.

Yorkshire Water notes that Ofwat proposed these changes to the notional structure (i.e. reducing notional gearing and/or increasing the index linked debt proportion) to the CMA as solutions for the notional financeability issues at PR19. However, alongside the rejection of the use of accelerated revenues, these proposals were ignored in favour of a more robust approach that ensured WACC was set at an appropriate level and then performing a financeability cross-check.

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The CMA was clear that WACC should be the primary factor when assessing financeability:

"the WACC is the primary factor in the redetermination ensuring that an efficient firm can finance its functions" [40]

and

"As a matter of principle, if the WACC is set at a reasonable level, both debt and equity investors should earn sufficient returns to cover the costs of financing" [41]

Yorkshire Water is concerned that Ofwat appears to be continuing to seek to address financeability in part by adjusting the notional capital structure; without considering the primary role of WACC and without an in-the-round assessment of risk and returns.

The CMA provided a significantly enhanced financeability analysis to that conducted by Ofwat at PR19, which should be adopted as a precedent and starting point for any financeability analysis at PR24 and future price reviews.

Looking further at the two specific examples provided by Ofwat:

Notional gearing

Yorkshire Water rejects Ofwat's assertion that companies have been "adopting risky financing strategies in order to arbitrage gains for investors", which was addressed by the CMA during its review and disregarded in its final report.

There is no evidence to support any reduction in notional gearing from the current level of 60%.

Notional gearing should be set at a level that is consistent with the range used by the credit rating agencies for the target rating assigned to the notional company

[40] CMA final report, p1116, para 10.72
[41] CMA final report, p1121, para 10.89

(BBB+/Baa1 at PR19). The CMA noted "this range relates to a notional target level from the credit rating agencies of around 65-70%"[42]

Average sector gearing in 2020 was 70.6%, with the gearing of equity-based companies ranging between 64.5% and 82.1%.

Average sector gearing reduced very slightly from 2015 (71.4%) to 2020 (70.6%). As a result of the efficiency and performance challenges within PR19, Yorkshire Water sees little scope for a greater reduction in sector gearing during AMP7.

In light of the above, Yorkshire Water believes that if there were to be any adjustment to notional gearing, then it should be an increase and not a reduction.

Whilst a reduction in notional gearing can be considered a potential mitigating solution for sensitivity analysis on financeability, it should not be considered a base assumption for the notional structure. It is critical that the base assumptions are consistent with those used by the ratings agencies for the chosen target rating of the notional company and that these assumptions are applied consistently across all relevant components of WACC and financeability.

Finally, we note the reference to a 5% equity issuance allowance in Ofgem's RIIO-2 final determinations, which is linked to new notional equity to support a reduced notional gearing. Yorkshire Water believes that this is a distraction from presenting the valid reasons and supporting evidence to reduce notional gearing.

Share of index linked debt

It is not clear as to the reason for selecting certain elements of the notional structure to be based upon actual sector data, but not other elements.

If this element of the notional structure were to be based on actual sector data, then it would be important to ensure that other debt related elements of the notional structure

[42] CMA final report, para 10.99c

(gearing percentage and proportion of new debt) were also primarily based on actual sector data to ensure consistency across all elements.

If a sector actual approach were only applied to one element, such as the proportion of index linked debt, then it would appear clear that this one area had been specifically chosen purely to try to resolve a potential issue with a financeability assessment, despite the clear guidance from the CMA that WACC should be the primary factor when assessing financeability.

It is elements of inconsistent selection such as this that can seriously dent confidence in the regulatory regime, eroding the financeability of the sector, which ultimately drives up long-term costs for customers.

With the full transition to CPIH proposed in question 11.8 below, it will also be important that index linked debt costs are recognised on a CPIH real basis, rather than the current RPI real basis.

In summary:

- The CMA's approach to financeability testing should be adopted as the precedent for PR24 and beyond.

- WACC is the primary factor when considering financeability, the notional assumptions should not be amended purely to resolve potential financeability issues theoretically.

- Any amendments to the notional structure need to be supported by strong evidence and be applied consistently.

- There is no evidence to currently support a reduction in the level of notional gearing.

- If actual sector data were to be used to support a change in the notional assumptions, then actual sector data would need to be used consistently across all notional debt assumptions, not just one.

- Following a further transition to CPIH, index linked debt costs should be recognised on a CPIH real basis.

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

We are concerned that Ofwat is seeking suggestions to incentivise financial resilience without providing a clear rationale for its concerns on this matter. As noted by the CMA, water companies have demonstrated resilience through the 2008/9 financial crisis and more recently the impact of the Covid-19 pandemic.[43]

Prior to any new mechanisms, or derivations of previous proposals being introduced, it appears wholly reasonable that financial resilience is assessed more broadly, including consideration of:

- The long-term physical asset bases and stable demand that allow higher levels of gearing to be sustained if there is an appropriate level of regulatory return.

- Operational and financial performance achievable to generate the necessary cash flows to fund investment and to service capital providers.

- Liabilities, such as pension deficits, that are debt-like and often included in credit ratings assessments.

- Stability of the regulatory environment that provides confidence for the sector as a whole; with greater stability now than shown for PR19 and given additional protections such as the recent ring-fencing provisions.

[43] CMA final report, para 9.1203, p1045

- Investors bearing the risk of loss and the external assessment of credit worthiness (e.g. by credit ratings agencies and debt capital markets) provides a strong culture of 'checks and balances' for risks around financial resilience.

- Bespoke financing arrangements for individual companies that establish obligations more thorough and tougher than licence requirements, with protections to constrain management's freedom of action and to mitigate service disruption for customers. For Yorkshire Water, this is the case with its securitised financing arrangement that has inbuilt restrictions and mechanisms including prospective covenants, dividend restrictions and standstill periods.

All of these aspects would be part of any assessment, by a company and its board, when confirming business plans are financeable and resilient on an actual capital structure basis.

For context, Yorkshire Water notes that:

- Ofwat has introduced additional protections with recent licence modifications, following the consultation on ring-fencing provisions.

- In line with other water companies, Yorkshire Water carries out long-term viability assessments annually, extending out to 2030, which consider financial resilience in the event of several scenarios with a negative impact on operational and/or financial performance.

- Past experience in the sector (e.g. Wessex Water and Dwr Cymru) has shown the existing regulatory protections have been deployed successfully without obvious harm to either customers or taxpayers; and

- Gearing levels have been broadly consistent during the last 10-15 years, with water companies successfully navigating both the global financial crisis of 2008/09 and the current Covid-19 pandemic, without evidence of financial distress. Indeed, water companies were required to provide support in 2020 to non-household retail companies as they struggled initially with the impact of Covid-19 on their low margin business models.

Furthermore, in its recent review, the CMA noted there was no evidence to support Ofwat's various assertions to justify the introduction of the gearing outperformance sharing mechanism ("GOSM")[44]. Therefore, it is extremely disappointing to see Ofwat's continued reference to "risky structures" and "distorted incentives" when identifying the need for further measures to strengthen financial resilience. Yorkshire Water believes firmly there is sufficient protection in current licence conditions and special administration measures, when considering risks around financial resilience. Also, it does not appear the best approach to address any genuine concerns currently on financial resilience by waiting to introduce mechanisms in four years' time, following the conclusion of a price review process.

Yorkshire Water notes that financial resilience is defined in Ofwat's document as "the extent to which an organisation's financial arrangements enable it to avoid, cope with and recover from disruption" [45]. This definition is interpreted reasonably as considering financial resilience company by company and for all companies; assessing a wide range of factors and the different financial arrangements that exist across the water sector. This should include consideration of market prices for publicly issued debt, which provides an indication of risk viewed by debt investors of water companies with different financing arrangements and profiles.

Therefore, Yorkshire Water does not see how the repeat of any general, narrowly defined mechanism, such as an amended GOSM, would be appropriate for PR24.

When assessing financial resilience, Yorkshire Water believes this needs to take into account historical financial performance and actions taken by companies on resilience in addition to financial arrangements and structures. This will ensure there is a more "in-the-round" assessment of a company that has a long-term perspective and would provide more substantive evidence for any financial resilience concerns. In addition,

[44] CMA final report, p36, para 102
[45] PR24 and beyond, p120, Section 11.4.2, para 1

Yorkshire Water supports the CMA's earlier suggestion that any mechanism is subject to a cost/benefit analysis. [46]

Therefore, Yorkshire Water believes a good starting point would be for Ofwat to set out the structural risks that it considers threaten financial resilience and what it means exactly by "distorted incentives". This would allow a reader to distinguish the reasons for any new mechanism(s) from those presented to the CMA in support of the introduction of the GOSM; being benefits not shared with customers, a transfer of risk to customers and/or taxpayers, addressing a gap in the regulatory regime and providing an incentive to reduce gearing.

Yorkshire Water hopes the points noted above will be considered fully by Ofwat as it prepares its discussion paper this autumn.

In summary:

- Yorkshire Water does not believe any additional mechanisms are required to incentivise financial resilience because:

- There are already adequate measures in place across the industry to protect against the risk of financial failure.

- Yorkshire Water, through its securitised structure, already has enhanced protections in place in comparison to non-securitised companies; and

- The risk of customers or taxpayers bearing any cost of financial failure is considered very low, with the CMA finding no evidence to suggest that they would bear material harm.

[46] CMA provisional findings, p659, para 9.630

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?

In light of the current proposal by HM Treasury to transition RPI from 2030 onwards and the full transition to CPIH by Ofgem, subject to Ofwat's draft methodology, Yorkshire Water sees no reason not to transition fully to CPIH at the start of PR24.

Yorkshire Water believes this is better than a continued transition for another five years and sees the continued split use of RPI and CPIH in PR24 would maintain additional complexity to the calculation of elements such as RCV and WACC.

Yorkshire Water notes that if the proportion of RCV indexed to CPIH is increased from PR24, then the real cost of debt included within the financeability assessment would need to be a CPIH based real cost of debt, rather than the current RPI based real cost of debt. This would be consistent with the change made by Ofgem when transitioning to CPIH.

For the avoidance of doubt, Yorkshire Water also notes that fully transitioning to CPIH has no impact on the TMR assessment and the relative merit of historic RPI and CPI based data used to determine TMR.

Additional Q1: cost of equity cross-checks - We are interested in views on other approaches which could potentially serve as cross-checks to a CAPM estimate

Yorkshire Water believes that the CAPM model remains the best way of calculating the cost of equity; however CAPM provides a wide range of potential options for the cost of equity, meaning a point estimate needs to be determined from within that range.

It is critical that the point estimate of WACC (and hence the cost of equity) is set at a level that encourages the right level of new investment. If the cost of equity is set too low, companies will be unable to attract the desired investment to develop and implement new and complex investment programmes that deliver enhanced service for customers. Conversely if the cost of equity is set too high, customers could end up paying for excess investor returns.

As noted by the CMA it is likely that the lower end of the CAPM range would result in credit metrics that are lower than necessary to support the desired investment-grade credit metrics for the notional company.

Yorkshire Water agrees with the conclusion of the CMA that financeability testing therefore provides the most relevant cross-check on the choice of the point estimate within the CAPM range of cost of equity[47].

This cross-check involves the use of credit ratios to confirm whether the cost of equity has been set at a level that is broadly consistent with the target rating determined for the notional company and implied within the cost of debt. This enables a minimum financeable level for the cost of equity to be determined, ensuring that the WACC is not set too high nor too low.

This ratings metric based approach is critical, as it ensures that the WACC assumptions are consistent with the notional credit rating assumed throughout the price review and hence the overall determination, 'in the round', has been consistently applied, ensuring a fair balance of risk and reward. This is a key element of ensuring the financeability of the sector as detailed in the introduction to this section.

Yorkshire Water does not believe that the two other commonly used cross-checks, market prices for assets ("MAR") and broker estimates, provide as good a cross-check as financeability, with both methodologies suffering from significant limitations, as detailed further below.

Both MAR and broker estimate data are currently limited by the fact that data is only available for 2 of the 17 companies within the sector. Whilst this is expected to increase to 3 companies, it still represents a very small proportion of the overall sector; therefore does not provide a valid estimate for the sector as a whole.

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[47] CMA final report, Para 9.1399

MAR data presented at PR19 showed significant variances between the listed companies in the sector, despite the companies being presented as very similar, highlighting that no valid conclusion can be drawn from such a small subset of data.

In addition MAR calculations are subject to a number of subjective adjustments, as illustrated by the significant range of different MAR values presented over the course of the PR19 CMA appeal. On this basis MAR analysis cannot be considered a worthwhile cross-check.

Broker forecasts, while also being severely limited by the small sample size, are also limited to the views of a small number of individual brokers, who might be tailoring their opinion to a particular investor, or a "house" view, not the cost of capital demanded by an average or marginal investor within the sector. The number of broker forecasts available is also currently decreasing and expected to reduce further as banks and credit institutions continue to cease non-core activities.

There is also likely to be an element of circularity within any broker estimate, as the broker is likely to assume a cost of equity close to that set by the regulator, rather than conducting their own detailed assessment.

Additional Q2: Proportion of new debt - We are interested in exploring how much weight we should place on company submissions and notional profiles when setting our assumption

Yorkshire Water believes that both actual company issuance data and notional profiles have a role to play in determining the proportion of new debt.

Which of these measures has more prominence should be linked to the methodology used to determine the cost of embedded debt to ensure consistency. For example, if a balance sheet approach is adopted for the cost of embedded debt as suggested by Yorkshire Water, then an actual company issuance approach would be more appropriate to ensure consistency, or alternatively, if an index-based approach was adopted then a notional approach, based on the trailing average period of the index would be most appropriate.

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In addition, if other elements of the notional structure (such as the proportion of index linked debt) are amended based on actual sector data, then an actual company issuance approach should also be applied to ensure consistency.

As discussed above in question 11.4, any notional approach should be based on the tenor at issue, not years-to-maturity, as this would incorrectly, significantly overstate the proportion of new debt.

When calculating the proportion of new debt under either methodology it is also important to recognise that an element of additional PR24 debt will in fact be indexation of existing debt and not "new" debt.

In line with Yorkshire Water preference for a balance sheet data approach to the cost of embedded debt, Yorkshire Water believes actual company issuance data should be the primary factor when assessing the proportion of new debt.

Additional Q3: Single cost of debt allowance - We note that there may also be potential to simplify this area by not making separate allowances for new and embedded debt

Yorkshire Water does not have any specific objections against a single cost of debt allowance but does not believe this would present a simplification as suggested by Ofwat.

Whilst a single cost of debt allowance might initially appear more straight forward to an external reader, Yorkshire Water believes the calculation of any single allowance would actually be more complicated than the current methodology.

This is because calculating a single allowance would require the following two steps, whereas the currently methodology requires only the first step:

1. Forecasting of new debt required each year and comparison to embedded debt at the beginning of the period.

2. Calculation of a combined cost of debt for each year, plus calibration to an appropriate index.

Yorkshire Water believes this second step, particularly ensuring calibration to an appropriate index, would be time consuming and complex, whilst providing no tangible benefit. Ofwat themselves note that "it may be difficult to capture the key characteristics of water bond issuance in any one index" suggesting that the calibration process may not be possible.

In addition, a single allowance would mean that an index-based approach would have to be adopted in reality, even if it was initially calibrated to actual data, which would result in consistency issues for PR29.

In summary, Yorkshire Water believes Ofwat should retain the current dual allowance approach because:

- A single allowance would bring additional complexity, not the simplification suggested
- Yorkshire Water prefers a balance sheet approach to an index-based approach
- The inconsistency of an index potentially calibrated to actual data at points in time hinders long-term financing strategies

Additional Q4: Retail margin – We are interested in views on how best to approach these issues

As a result of the working capital issues experienced by retail companies during the current Covid-19 pandemic and the additional financial support provided by wholesale companies, Yorkshire Water believes that a detailed review and further consultation is required in relation to the calculation of the retail margin deduction. In particular:

- The net working capital days for a notional retail company requires further assessment. In light of the additional working capital support provided by wholesale businesses, the CMA's assumption of nil net working capital days appears to be insufficient and not reflective of market practice. Further consideration of the specific working capital balances included is also required to ensure that any creditor balances included are not effectively intra-company balances between retailer and wholesaler.

- A "sense check" of the impact of the proposed retail margin deduction on the actual retail margin is required. For example, the CMA's 0.08% retail margin deduction equates to a retail margin of only c0.2%, with the balance of 0.8% being due to additional systematic risk. Stepping back, a retail margin of only 0.2% appears very low in contrast to other industries, whilst the fact that wholesale companies had to financially support retail companies during the recent Covid-19 pandemic suggest that the retailer is not bearing any additional risk, it is the wholesaler that is continuing to bear the risk, and is indicative of the market not operating as envisaged.

12. Next steps for PR24

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

As outlined in previous responses, we have set out our preference for the provision of early information to be in line with the publication of the draft and final methodologies. This will be vital for ensuring that companies have appropriate time to plan and provide well evidenced submissions. It would clearly not be in customer's best interests if the regulator took a year and half to arrive at a final methodology, to then only allow companies 6 months to submit a plan on that basis.

We have no substantive comments to make on the draft timetable itself, however it would be helpful for Ofwat to provide specific dates for each of the key milestones as early as possible. Defined dates allow companies to plan resources appropriately; the current consultation had very little advance notice and arrived two days before a bank holiday weekend and the start of school half term. We would politely encourage Ofwat to consider all stakeholders in the timing of publications.

14. Appendix – Examining the boundary for targeted water resource controls

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

and:

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

We have set out our comments in respect of the water resource price control in our response to question 8.2.

In summary, we agree that water resources cannot be treated as a distinct business, akin to bioresources, as water supply is an inherently vertically integrated operation from catchment to abstraction to treatment to supply. That is also one of the reasons why it is so resilient, we take operational decisions based on a holistic view of the system, not by price controls. We can balance supply with demand across the region by using our raw and treated grids in an integrated way.

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Bioresources Market Review

Q1: Do you agree with, or have any comments regarding, Jacobs' bioresources market review report?

and:

Q2: Do you agree with, or have any comments regarding, the proposals and views we set out in this document?

Our responses to the issues outlined in the consultation are set out below:

Ofwat Issue 3 - Cost assessment

We propose a variant on option 1. The building blocks approach should be retained. But, as an evolution to the current hybrid approach, we consider that an average revenue control has some merit; especially if the cost of capital is uplifted to reflect the associated increase in demand risk. Furthermore, given the data improvements provided for under issue 2 we consider that a fuller Totex approach to cost assessment should be trialled. In our opinion the allowed return on capital should continue to be determined separately. Although to avoid capex bias in the cost assessment process, the associated (annualised) fixed capital cost could be integrated into the benchmarking exercise.

Other issues: Cost of Capital

Ofwat states that "we consider that increasing sewerage companies' allowed revenues by using an unduly high allowed return on capital would not be in customers' interests. Therefore, we do not intend to promote competition in this way by raising companies' returns".

However, BEIS allows for much greater returns for Anaerobic Digestion (AD) in the "other organic waste" market segment than Ofwat does for bioresources. Given the continuing scale of the inconsistency, for new bioresource capacity (i.e. post 2020 RCV), we would like to keep this discussion point open; [noting that the pending decision on whether import electricity prices, export electricity prices, an average of these and/or some other benchmarks (such as the newly proposed GGSS tariff) are used to value energy at the bioresource boundary is also germane to any level playing field discussions.

Ofwat Issue 1 – Market models

We agree with Ofwat's preferred option and its suggested implementation. This will "ensure clear, objective and non- discriminatory consideration of third-party bids when tendering for significant work". We're keen that each company should design and publish their own approach, learning from their own experiences from the water bidding market and utilising work already carried out this AMP (i.e. our Strategic model).

We also agree that uncertainty around regulation of long-term contracts is a challenge still to be addressed, and further guidance is would be beneficial in this area. It may be appropriate to carry over some relevant features from Direct Procurement for Customers (DPC) to support this.

We agree that resilience of third-party contracts is essential to consider when evaluating options; without it water companies may end up holding spare capacity in case of failure incurring further costs.

Ofwat Issue 2 - Cost allocations

Ofwat has focussed on two important control boundary issues: a standard methodology for calculating sludge liquor treatment costs and developing new guidance on energy generation revenues (and overheads). We agree with this twin boundary focus as there have clearly been "significant/material variation in [sewerage] companies' approaches". And the associated sludge liquor costs/energy revenues are so material that this "variation" will have impacted the robustness of the bioresource econometric models developed by Ofwat during PR19. We plan to comment on the recently published consultation on the proposed "methods to improve the allocation of energy costs and revenues in bioresources" separately.

Ofwat Issue 4 - Planning and Collaboration

We agree with Ofwat's preferred option to encourage greater sector collaboration. We would encourage and expect companies to work with the sector in a transparent and proactive way, including through regional collaboration where appropriate.

We are already working with our neighbouring WASCs to develop the market for trading, having done a lot of short term trading out of Yorkshire, and are now in a position to offer opportunities to trade short-term into Yorkshire. We are planning on a outsourced market solution for our capacity requirements, which will be open to other WASCs to compete in.

This avoids Option 2 which would require Bioresources Management Plans (similar to water resource plans). Whilst we could do this, it would be a lot of work and we are not clear where this would provide better information to market participants. We could choose to offer to publish a "light" version of this on our website, although there may be some duplication with the proposed BAF.

Under Option 1 we should show clearly the work we do on joint innovation in technology; understanding and working with environmental regulation, etc, and also how we use the market information that is already shared, and ensure this is highlighted in our PR24 plan.

Ofwat Issue 6 - Outcomes

We agree with Ofwat's preferred option 3; Ensure definitions for any bespoke bioresources PCs are appropriate and explore potential for common bioresources PCs, with some minor caveats.

This would allow for company specific performance commitments but would explore if any of the 'most common' bespoke bioresources PCs can be made common at PR24.

Different performance commitments do drive different behaviours, standards, and costs and this would enable better comparison between companies for Ofwat and customers.

As an example, we have committed to 100% BAS assured recycling to agriculture. This has caused us some operational issues and cost, and we have maintained compliance with this but at additional costs. We are aware that other water companies do not have the same commitment and have failed BAS Assurance standards. Our treatment of energy and carbon through our performance commitment is also different to other water companies. It is therefore difficult to determine how we perform compared to other water companies, and if carbon is truly being reduced rather than being offset. Under an econometric model this may mean that costs being modelled do not reflect the risks and performance being delivered. We note that sludge is also no longer included in the EA annual environmental impact, again making comparisons of the performance of the different water companies difficult to determine.

We should be cautious about creating the need to measure more and more things. Our reporting burden has increased significantly over the last five years, with large increases in market data reporting, as well as changes in the information required for APR.

Issue 7 – Trading Incentives

We agree with Ofwat's preferred option. "Adding a further distortion to the market would be inappropriate at this time". The priority should be removing some of the market blockers discussed.

Jacobs Report

We agree there is significant market opportunity which is at least in-part untapped due to constraints such as regulatory uncertainty. Part of the challenge is also

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timing, as the cost of new capacity only really becomes viable if there is a sudden increase in sludge production or assets reach end of life. For instance, we expect to have a shortfall in sludge treatment capacity and expect to go to market for an outsourced offtake contract, but this requirement doesn't materialise until the end of the AMP.