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Via email: [REDACTED]

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Dear [REDACTED]

Ref: PR24 and beyond: Long-term delivery strategies and common reference scenarios

Thank you for the opportunity to comment on Ofwat's discussion document on long term delivery strategies and common reference scenarios. Long term planning is intrinsic to the way our sector operates, and vital to ensure the success of the sector in continuing to deliver high quality supplies of water. We welcome the increased focus on placing business plans into the long-term context, both in this document and in the PR24 discussion documents published earlier in 2021. We are committed to embedding the long-term context in our activities and plans, and have recently published our Strategic Direction Statement, setting out our own long-term ambitions, which we view as an essential first step in developing our plans for AMP8 and to 2050.

There is much to be welcomed within the discussion document. We think that the approach to bring together the key strategic decisions companies are facing, focused for the water service on the WRMP, Net Zero and potentially lead pipe replacement, will deliver benefits for customers and the environment by ensuring decisions are made in a timely manner, and will deliver best value for customers. We welcome the intention to consider plans against common assumptions, which will mean that long term plans across England and Wales can be viewed on a comparable basis. We also agree that any long-term strategy should be based on customers' priorities, and insights gained from high quality customer and stakeholder engagement.

That said, we think Ofwat's current proposals need significant simplification in the interests of the industry preparing successful, high-quality long-term delivery strategies and in the interests of Ofwat successfully scrutinising and comparing these strategies at PR24. Ofwat is currently proposing to collect a large amount of additional information and data as part of this exercise which will considerably add

to the regulatory burden. We want to be assured that the additional information is required and is the minimum needed to meet the purpose of the exercise.

We note some overlap with the WRMP process, a process which has developed over multiple regulatory cycles and is now well established. We also note there is a misalignment in timetables, so that we will be unsighted on Ofwat's final proposals as we prepare our draft WRMP. We seek reassurance that Ofwat does not intend their proposals for long term strategies become overly burdensome for companies who have existing obligations under the WRMP process.

We have a number of comments on the detail of the proposals set out in the document, which we set out in an annex to this letter. We also set out an alternative which we think delivers the primary objective of transparency about the key decision points and alternative pathways available, while remaining proportionate for companies.

We propose that companies should set out between two and four pathways, perhaps limited to a core pathway with alternatives for a more challenging and a more benign future. We think, pragmatically, there would be one pathway for AMP8, with options and key decision points included for AMP9 and AMP10.

The scope of the pathways would include WRMP and the path to Net Zero. We think there may be some merit in including a separate pathway focused on lead if significant ambition for lead replacement is included in Defra's final Strategic Priorities Statement. We think this should be separate as the scenarios to test that pathway against would be very different to those for WRMP and Net Zero, as alternative pathways would be shaped by Government policy, geopolitical conditions (for example affecting the availability and cost of chemicals for dosing) and customer acceptance of the disruption involved within their properties rather than factors such as climate change and population growth.

We propose that within the scope of the pathways there would be a materiality threshold. This could be set at £100m totex, in line with the DPC threshold. This would allow the pathways to be useful for potential DPC investors to assess the viability and risk profile of potential investments. Alternatively, the threshold could be based on a cost:RCV ratio, or threshold increase in RCV such that the scope was of a similar proportion for each company, regardless of company size.

We think the scenarios should be few in number, and based on two axes of influence, environmental and societal. The environmental aspect would describe a range of potential outcomes from low environmental health, where the environment is deteriorating in terms of quality and quantity, and a high environmental health outcome, where it is high quality and continuing to improve. The societal aspect would similarly show a range from low to high quality outcomes, and the two axes combine to produce four scenarios, each distinctly different but credible. This approach would have the advantage of making the scenarios cover a much wider range of potential future outcomes, whereas currently we think some of the 'high' and 'low' parameters set out in the discussion document are relatively narrow.

We agree that it is important to understand the impact on customer bills of companies' future investment, and we think setting out the bill increment in terms of an incremental increase to the nearest pound (all other things being equal in botex) would be the most useful information that both customers and policy makers can be consulted on. We think it is important not to create spurious accuracy with projections over 25 years to the penny, and in the absence of any of the other significant drivers of customers actual bills such as capital maintenance and inflation. We also think the current data table proposal suggests that the total bill is being forecast under the core scenario and each adaptive pathway, when this is not in fact the case.

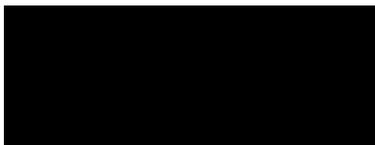
We hope that these thoughts are useful contributions to Ofwat's thinking in this area. We would be very happy to continue further discussions with Ofwat and to participate in further industry workshops or working groups on this topic.

In summary, while we fully support and agree with the principle that companies should place their business plans in the context of the long term, we have concerns over the complexity, the substance of the proposals and the process that has been followed. As mentioned above, we set these out in an annex to this letter.

We recognise the importance of this issue to the future of the sector, and are keen to work with Ofwat to develop a pragmatic and effective long-term framework within which PR24 can be placed.

As always, we would be very happy to meet to discuss our comments further, and look forward to future engagement with Ofwat on this topic.

Yours sincerely,



Interim Regulation and Strategy Director

Annex

In this annex we set out our concerns over Ofwat's current proposals for long term strategies and scenarios, and proposals for a workable long term delivery strategies and common reference scenarios framework.

Key assumption – limiting to enhancements only

We are concerned to see that the framework focuses on enhancement expenditure only. This is problematic for a number of reasons. We suggest a number of workarounds that will make it clearer that the long-term delivery strategies only cover part of our business.

First, any discussion of impact on customer bills will be misleading, as under half of totex will be represented. We think it is potentially unhelpful to create profiles so far into the future, that are not representative of the actual bills customers will experience, once base expenditure and inflation are taken into account. Hence, we think it is important to make clear that the analysis is indicative (subject to future decisions about pathways and future decisions about expenditure that is not in scope of the planning exercise) and is presented in real terms, base year prices. We note that the environmental and societal factors that are likely to influence enhancement expenditure are also likely to influence our activities in base expenditure.

Second, we think there will need to be an assessment of base investment for the enhancements we are considering within our PR24 long term scenario planning (e.g. leakage and PCC), because the data tables require companies to split performance projections between those anticipated from base and those anticipated from enhancement investment. To understand the performance anticipated from base over 25 years, which we think Ofwat intends to do as part of this long term planning exercise, companies will need to forecast the overall expenditure associated with that performance and split it between base and enhancement. If the scope is limited to some or all of the enhancement expenditure, we think an appropriate caveat in the presentation of the bill increments is needed to avoid misleading customers and policymakers. For example, pounds increase due to enhancements, or present an itemised set of bill increments due to WRMP, net zero, and potentially lead pipe replacement. The presentation needs to caveat that only a subset of the total running costs are included in the increments presented. We think that presentation of a bill increment in pounds (to the nearest pound to avoid spurious accuracy) is more helpful than a percentage increment which may imply that we are forecasting the total bill.

We note that the environmental and societal factors that are likely to influence enhancement expenditure are also likely to influence our activities in base expenditure. As we have set out in our letter dated to Ofwat cost Assessment Working Group – Forward Looking Capital Maintenance) we strongly believe that capital maintenance investment will need to increase in the long term. To exclude

the base expenditure forecasts long-term, further mislead customers and stakeholders over the potential bill impacts. We think this should be mitigated by making clear what is included and excluded in both companies' and Ofwat's presentation of the long term delivery strategies, potentially by presenting itemised bill impacts in pounds for each investment area in scope, and by avoiding percentage increments. The current references to "average total bill" in the block descriptions in Table LS7 are incorrect and misleading.

However, if the focus is to remain on enhancement, we think it should be clear which parts of enhancement are to be included.

For these reasons, we think that bills should be represented as pounds increments for specific areas of enhancement expenditure to the increment due specially to that enhancement to the nearest whole pound. The current labelling in the table implies that this is an overall bill impact (when the scope is not all of the expenditure) and the values required in the data tables are too granular, to the penny. We also think that the enhancement investment within scope should be clarified to ensure these proposals are focused on material investments with significant decision points over the 25-year time horizon.

Long term delivery strategies

We welcome the opportunity to set out our PR24 plans within the context of our long-term ambitions. We have recently refreshed our Strategic Direction Statement and set out our long-term ambitions, work that was underpinned by customer and stakeholder engagement. We see this as the first important step in developing our PR24 strategies and plans.

We agree that our purpose, vision and strategies should always be driven by our customers' views and preferences. We recognise the difficulty in engaging with customers on long term, uncertain plans and potential outcomes, and welcome Ofwat's acknowledgement of that in the document.

In order to reduce the risk of discussion on strategies being diverted by conflicting customer research, we think Ofwat should consider increasing the scope of the national research currently being scoped for PR24 to include a long-term element, to help gain a national view of what the priorities should be for companies over the long term.

We agree that the components Ofwat has set out for strategies are necessary and useful. However, we have a number of concerns about the potential implications for the detail of Ofwat's proposals.

We agree that companies should set out a core pathway with defined triggers to move between pathways. However, we are concerned over the implicit assumption that only investment needed to meet short-term needs, the requirements set out in the low scenarios and limited preparation for other outcomes should be included. This implies that the current trajectory and short-term outcomes

follow the low scenario, and there is no assessment as to whether that is justifiably the case. We do not think Ofwat can do this alone. It is for the Environment Agency, DWI, Ofwat, CCW, Government and the industry in partnership with customers and other stakeholders to understand the detailed requirements including the required level of ambition, which are likely to vary for each company. These requirements will take time to develop and need to be owned by companies who may not consider that Ofwat's definition of the core pathway matches theirs.

Ofwat's assumption is contrary to what we hear from our customers and stakeholders about their expectations of us. They do not want us to deliver the bare minimum. They want us to use our unique position as regional suppliers to deliver a service intrinsically linked to the environment, to go above and beyond and create real value for customers and communities. We think that constraining companies to the lowest scenario restricts our ability to deliver those expectations.

For these reasons we think that we should set out a central scenario as the core pathway, with alternatives covering both a more challenging future, and a more benign future. This will enable customers and stakeholders to provide their views through consultation on the extent to which they wish us to go further than the bare minimum.

Scope

We think that there is a lack of clarity about the scope of investment and activity included. This is because Ofwat expects a degree of assessment of the service that can be delivered from base, which means that the scope as currently drafted involves consideration of enhancement costs and a proportion of base expenditure to deliver an assessment of the factors Ofwat has included. It is not relevant that Ofwat has not asked for reporting of the base expenditure assessment – companies will still need to undertake this to understand the cost of future performance improvements relating to the common PCs. We think that this needs to be made transparent in the guidance, and that given that a mixture of base and enhancement is being considered there is a case for considering limiting the scope to the areas of greatest material concern, regardless of expenditure type.

There is a risk that, if the scope is not limited, Ofwat will find that a very complex and granular picture emerges that is difficult for it to interpret in practice. We think that the goal should be to understand the key material items that are likely to raise significant concerns, rather than every enhancement activity on a 25-year horizon. We think that limiting the scope is likely to be required to avoid unwieldy numbers of adaptive pathways. If the guidance is left more generic, and only verbal assurance that the expectation is a limited number of adaptive pathways is given in a workshop, there is a risk that the industry will not deliver the analysis that Ofwat wants or needs.

We note that the draft SPS states that the industry should “shift towards” long term adaptive planning, which does not suggest a wholesale adoption of long-term planning across all enhancement activities is necessarily proportionate.

We want to see an assessment by activity type (e.g. by individual PC, and by investment type) of whether Ofwat's concerns can be addressed through assessment of plans for the 2025-30 period, or whether the activity would benefit from a 25 year view, and if so why that is the case.

We think that, in the interests of simplification, the scope should be limited to a subset of enhancement totex (and any associated delivery in base) that:

- Is likely to be sufficiently material in size (e.g. >£100m totex) that introducing alternative adaptive pathways could make a significant change to the scale of our future plans, and it is therefore proportionate to consider in the long term.
- Is likely to have a significant sensitivity to uncertainty, so that scenario analysis is a valuable test for the category of investment, to establish the robustness of plans and is therefore likely to impact the two alternative adaptive pathways we set out above.
- Minimise the scope that is not already included and costed in one of the existing long term planning frameworks (i.e. the WRMP and DWMP frameworks).

We think that the long-term delivery strategies need to be targeted towards the areas of greatest concern to Ofwat to avoid excessive burden being placed on the companies for limited benefit to society.

We propose that the scope could be limited to the following categories of expenditure, which we believe would address Ofwat's key concerns and represent a reduction on the burden proposed in Ofwat's discussion paper:

- A subset of the common performance commitments, limited to those where customers or policymakers have indicated that a step change in performance is required or particular sensitivity to environmental or societal factors.
- Investments to achieve net zero operational and embedded greenhouse gas emissions.
- Investments set out in the WRMP.
- Potentially lead pipe replacement where there is uncertainty about future policy direction, and about societal response to a programme of replacing customers' internal pipework.

For these reasons we think that the scope should include only those common PCs where a significant step change in performance is supported by customers or policymakers, the WRMP and potentially lead pipe replacement.

Scenarios

We agree that it is useful to use scenarios to help develop and test strategies for the long term. This approach is set out in the Water Resources Planning Guideline which we are following in developing our WRMP24.

We are concerned that the scenarios set out by Ofwat are different from those required by the planning guidelines. In particular, the list of considerations in section 9.2 of the Water Resources Planning Guideline emphasises societal benefits (such as improvements to public health and wellbeing) which we think are not reflected in any depth in the scenarios Ofwat sets out. It is also unclear how Ofwat considered the extent to which the scenarios are consistent with the considerations set out in section 10.9 of the Water Resources Planning Guideline. We think that it is important to reconcile with existing adaptive planning methodologies and practice (e.g. through the regional planning groups) in the interests of reducing the regulatory burden and making the PR24 long term delivery strategies as consistent as possible with other plans. We want to see Ofwat scenario planning guidance that maps closely to the requirements of the WRMP, which is a statutory document. We are particularly concerned that if a different approach is taken to scenarios, this could undermine consistency with the regional plans, which will be finalised at the time Ofwat assesses business plans, and potentially lead to AMP8 performance expectations that differ from those in the WRMP. Inconsistencies in approach between the two could undermine our case of need, particularly with regard to whether the core pathway assumptions are appropriate for our operating area and circumstances.

We consider that societal benefits should be considered broadly. Societal benefits are more than affordability and vulnerability, this should be about considering potential levels of utility to our entire customer base and evaluating whether there are trade-offs with environmental outcomes.

We note and agree with the characteristics of useful scenarios for planning in section 3.2. However, we do not think that Ofwat's scenarios conform to these characteristics. In particular:

- The technology scenarios are almost completely driven by water companies' own strategies and plans, and so are not exogenous.
- The technology scenarios are not materially different from each other in a number of aspects, for example a five-year difference in the timeline for implementing smart water networks, and ten years separating the adoption of low emissions fleet.
- The high technology scenario assumption on smart metering does not seem to represent a high technology scenario, given that Affinity Water is planning 100% smart metering by 2035, fifteen years ahead of the timing suggested by Ofwat.
- Technological change is inherently uncertain, and therefore seeking to define technology scenarios up front in a granular manner is not likely to lead to an optimal solution, given that unforeseen innovations are highly likely to arise. We do not consider the technology scenario to be simple in nature when considered more deeply.

- The climate change scenarios companies are directed to use are intended to be tailored to companies' geographical regions in contradiction to the principle that scenarios should be national.
- The demand scenarios do not consider any step changes in demand, from causes other than population growth and legislation, such as those seen in the Covid pandemic. There is a probability that we could see a further step change, either to increase or decrease demand due to unforeseen 'black swan' type world events in the next 25 years, including the possibility of mass migration to Northern Europe. Indeed, as our global society becomes ever more interconnected and complex, such events are increasing in frequency.

We consider that, as a point of principle, the use of a technology scenario is flawed, as technology is more often the result or an output of a scenario. It is an enabler rather than a driver. We also do not think that the implicit assumption in the paper, which is that increased technology leads to lower bills, is true. We have already seen this with leakage reduction, in that every company is already well beyond the economic level of leakage control, and we think that assuming a high technology scenario will cost customers less is incorrect.

Finally, Ofwat states that it will expect companies to 'clearly demonstrate' using scenarios that the long-term strategy is likely to deliver its ambitions, but it is not clear how Ofwat will assess whether companies have done that, what the output of the testing should look like, and what the impact is if companies are found to have fallen short. We think Ofwat needs to be clearer about how the assessment of the long-term strategies will dovetail into the assessment of business plans at PR24.

For these reasons we propose a simpler two-by-two matrix of scenarios to assess strategies. We propose these are based on environmental and societal axes, and that technology is recognised as an enabler and/or an outcome rather than a scenario in its own right.

Regulatory process and impact assessment

We have a number of concerns over the current proposals. The need for Board assurance effectively extends the business planning process from a five year horizon (with a look forward a further five years) onto a 25 year horizon, creating a considerable additional workload. We view this approach as a fundamental, wide-ranging and significant addition to the regulatory approach to price reviews.

As a minimum, we would expect there to be a regulatory impact assessment for this significant policy change, which would set out the rationale for change, evidence for why change is needed, and an assessment of the effectiveness of that change. As set out in The Better Regulation Framework, the first stage of an impact assessment should include setting out all of the policy options, with an estimate of the impact of each of these. These should then be consulted on, whereas in this discussion paper only a single approach is set out with guidance presented as a near final version.

In addition, in the consultation Reforming the Better Regulation Framework carried out between July and October 2021, the principle of regulatory offsetting is considered, as a way to ensure regulatory burdens remain proportionate and value for money for both individual customers and for the economy in general. There has been no meaningful consideration of options, consultation or assessment of burden for these proposals, and no consideration of reduction in burden in this document or any of the other discussion and consultation documents issued during November and December 2021.

As a result, we believe the proposals as currently set out in the discussion paper represent a disproportionate burden on companies, particularly smaller companies. Ofwat has not sought to assess or quantify whether there is a benefit for customers and relies on assertion that this is the case.

In addition to our concerns over regard to the principles of better regulation, we have a number of concerns over the process Ofwat has followed. The proposals have been presented as a discussion paper rather than a consultation, and with very little opportunity for companies to contribute to its development. Companies were offered a single seat at two meetings to discuss the proposals ahead of the discussion paper being published, with very little information to enable them to propose the most suitable delegate or prepare meaningfully. The workshop following publication of the discussion paper was limited to one hour long, and it was not possible to answer all of the industry's questions in the time given, demonstrating that the time allowed was insufficient.

The paper was issued at the same time as a number of other PR24 documents, very near to Christmas, with relatively short deadlines for comments to be received. We would have expected this paper to be a formal consultation, and we would have expected the deadline for response to have been at least that of a consultation, i.e. 12 weeks. We note that an extension was granted, however that this left the consultation period still significantly less than 12 weeks and we think that this falls short of the level of openness we would expect of a change of this magnitude.

We also consider that the timing of development of Ofwat's approach is not optimal. If the guidance for long term delivery strategies had been made available on the same timeline as the Water Resources Planning Guideline and guidance for the DWMPs, the industry would have been better enabled to harmonise their approach between PR24 and other long term planning frameworks. The current timing means that we are in discussions about how to accommodate Ofwat's guidance, which is only available in draft, into regional WRMPs that are already in flight (and ready for public consultation), and where the final guidance will not be available to us when we publish our draft WRMP.

These circumstances, combined with the nature and scale of the change that is being proposed, means that there is a risk of major changes to the regulatory framework being pushed through without sufficient time for companies to consider and respond to appropriately. We think it is important for all parties to acknowledge

that what is achieved at PR24 represents the first step in the journey towards fully integrated long-term planning, which as an industry can develop further with each price control.

For these reasons we are eager to work with Ofwat to ensure the final proposals are workable, proportionate and useful for the industry, customers and stakeholders. We think that significant industrywide collaborative effort is required to design a framework that is both fit for purpose and does not significantly increase the regulatory burden, and are concerned that it is already late in the planning process if we are to achieve consistency between the WRMPs/DWMPs and our PR24 plans.