

13th January 2022

Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

By EMAIL to: [REDACTED]

Dear [REDACTED],

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

This letter sets out Northumbrian Water's (NWLs) response to Ofwat's recent consultation "PR24 and beyond: Long-term delivery strategies and common reference scenarios".

We welcome Ofwat's approach to require companies to set out long-term delivery strategies and common reference scenarios. This will help to ensure that the final determinations for the 2024 Price Review (PR24) take a suitably long-term view for customers and stakeholders. We hope this approach can be retained and evolve for future price reviews. The water sector is characterized by very long-term asset lives and investment horizons and provides an essential service for customers and stakeholders, this makes the development of very long term plans essential. Planning and investing early can avoid inefficient incremental costs or greater customer detriment materializing later¹.

In this context we support the link explicitly between long-term plans and the next five years. This link between long term planning, and business plan needs assessment for enhancements, is well established for Water Resource Management Plans (WRMPs) and for example associated supply side interventions that may be required to address climate (drought) or demand risks. To ensure the success of the long term planning approach, it will be critical for this link to be established in a very similar manner for other, broader and newer aspects of long term strategies including but not limited to Drainage and Wastewater Management Plans (DWMPs). We have already commenced work to refresh our long-term strategy up to 2050. This will form a key part of the foundations for our PR24 plan.

We support the 'scenarios' proposed, this will provide some consistency whilst recognizing that there will remain lots of differences in the approaches taken across companies. We consider that the proposed 'scenarios' are in fact more like standard planning assumptions on particular key uncertainties for the future. We are developing plausible scenarios, which combine a range of drivers, to test and challenge our plans. We have already undertaken a comprehensive horizon scanning activity to determine drivers, and those key factors that have the highest impact and uncertainty. These will form the basis of our scenarios, which will describe plausible external worlds that our plans will need to be able to operate in. We expect to identify our long-term strategic objectives, and then use the scenarios to develop adaptive pathways with potential trigger points when we might need to

¹ By way of example the National Infrastructure Commission (NIC) has suggested that if £21bn is not spent on building resilience in water supplies over the next 30 years then the cost of relying on emergency options would be £40bn. See: <https://nic.org.uk/app/uploads/NIC-Preparing-for-a-Drier-Future-26-April-2018.pdf>

pivot our approach. At this stage we intend to present the impacts of the Ofwat 'scenarios' but in addition, for our PR24 submission, we intend to present these broader plausible scenarios as well.

Despite these common assumptions there are likely to be very significant differences between the approaches taken by different companies over such a long and uncertain planning horizon. Ofwat will therefore need to be flexible in how the results are considered and applied and the scope for comparative benchmarking and assessment will necessarily be very limited. We should embrace the opportunity for innovation and learning here rather than seeking prescription. Whilst there is some history and pedigree to long-term planning and scenario testing in the water sector, for example through the established Water Resource Management Planning process, the proposed approach to the development of long-term delivery strategies and common reference scenarios is novel and PR24 is different from what Ofwat has required of companies in the past, for example through Strategic Direction Statements. For example:

- the existing planning frameworks are partial with each framework covering only part of the value chain rather than a holistic whole;
- those frameworks are different, often having different guidance and assumptions and they are at different levels of maturity; and
- the approach outlined for PR24 seeks to provide more quantification and rigour in the development of long-term plans through modelling and scenario planning rather than through some of the more qualitative assessments that the sector has developed in the past, such as SDSs.

A further significant challenge is that the main planning cycles (WRMPs and DWMPs) are already well developed now even before Ofwat's approach for PR24 is agreed and the timescales for the delivery of those plans alongside regional plans for water resources are already very tight. This implies, as Ofwat recognizes, the need for adaptive planning to take place within those process effectively and results to be brought together in short order alongside the business plan submission. Moreover, establishing 25 year plans clearly has substantial uncertainty, this may be one of the reasons, for example, that Ofwat has chosen not to extend the price control period beyond five years² and the 'adaptive planning' approach is required. Given all the uncertainties highlighted companies will take very different approaches and make different assumptions, we should embrace this and promote innovation and rather than seeking comparative benchmarking and assessment which is unlikely to be feasible anyway and will reduce innovation by companies.

The approach should be wide and comprehensive, and we intend to take a whole-totex approach to the assessment rather than just look at 'enhancement' spending. Ofwat suggests that the planning exercise should be focused only on enhancement costs and the 'trigger events' associated with large and new lumpy investments. We absolutely recognize the value of considering the need for and sequencing of large and lumpy 'enhancement' investments to address key strategic risks in the future this will be a critical part of any long-term planning exercise. We agree with Ofwat's statement that *'this will have greatest impact and benefit most from the scenario testing and consideration of sequencing that long-term delivery strategies will bring'*. However, the approach makes an artificial distinction between 'enhancement' and 'base' expenditure which in practice is increasingly difficult to identify over such a long time horizon, in particular for service-driven enhancements and limits the value of a long-term planning exercise like this unnecessarily. For example, Ofwat has previously argued that it should be possible to improve service levels from base expenditure. This would be the case for example where the efficient marginal costs of service improvement can be accommodated within base allowances or where there are productivity and innovation improvements that can be

² 'PR24 and beyond: Creating tomorrow, together' Ofwat, May 2021, p.8

implemented but this will not be true in all instances³ and over time this distinction will become increasingly difficult to make. We intend to conduct our long-term delivery and scenario planning work using a whole-totex approach identifying new lumpy enhancements where we can but not limiting the work to those areas. We expect that this will maximise the value of this exercise and produce wider learning for the future.

We agree that the exercise should focus on assessing uncertainty arising from drivers that are ‘exogenous’ or outside of the control of companies but in practice again these distinctions are hard to draw and we don’t agree that some of the factors listed are within company control, including asset health and resilience. Whilst we agree in principle that factors inside companies’ control should not be the focus of uncertainty assessments for this work. However, over such a long time horizon it will be difficult to establish the level of company control and this will be a matter of judgement and debate. This is acknowledged in the consultation document which sets out categories of factors that are ‘not under company control’, some which are ‘partly under company control’ and some which are ‘largely under company control’. One of those listed in the last category is ‘levels of asset health and resilience’, there are acknowledged weaknesses in the existing approaches to assessing capital maintenance and asset replacement expenditure⁴ which could create a need for additional investment in the future and there are also uncertain drivers, such as climate change, which could drive requirements to replace existing assets with new or different and more sustainable asset types. Moreover, where Ofwat acknowledges that climate change and its impacts are ‘largely not under company control’ this will include impacts on company resilience that are driven by climate change. For example, the need for new investments to increase resilience to the escalating number and scale of extreme weather events that companies are subject to as a result of climate change. This is particularly the case where the regulatory framework places the risk of these events on companies and they can be subject to significant service performance penalties.

We are pleased to see that Ofwat recognize that there are challenges around engaging customers on very long-term planning and future scenarios. We agree that it will be important to engage customers on the level of ambition, strategy and rational as well as value for money of proposals and that this engagement evidence will need to be considered alongside other evidence. We agree with Ofwat that, despite the acknowledged challenges of this⁵, it is essential that customers are fully engaged on the level of ambition in future plans, including as far as possible the levels of service targeted, the risks and the impacts of other factors such as growth and resilience. Customers also need to understand the strategy and rationale for different pathways and associated trigger events as well as the trade-off with bills and affordability and be able to make strategic choices about what future state they would support and what they are prepared to pay for it. It will be extremely challenging to get this engagement right and we are exploring a range of deliberative approaches, including methods that allows us to consider the views of future customers. Balancing the challenge of this engagement

³ A Global Water Intelligence (GWI) market study in 2018: <https://www.water.org.uk/wp-content/uploads/2018/12/GWI-International-sector-performance-comparisons.pdf> looked at the percentage of non-revenue water compared to total distribution input this showed that those countries that had invested significantly more than others and replaced a larger proportion of their networks had lower leakage. The study implies that to reduce leakage further in the future (either driven by customer preferences or water supply challenges) may require significant changes in maintenance and replacement rates. The natural rate of rise in leakage also suggests this increasing marginal cost. Moreover we note that the CMA gave three appellants additional allowances to meet the current 15% leakage reduction targets for AMP 7 recognising that the base cost allowances were insufficient to meet these leakage levels (see: <https://www.gov.uk/cma-cases/ofwat-price-determinations#final-report>)

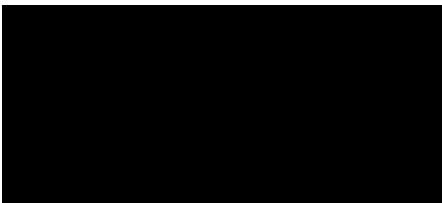
⁴ This was acknowledged by both the CMA (see: <https://www.gov.uk/cma-cases/ofwat-price-determinations#final-report>) and also Ofwat in its various PR24 consultations (see: <https://www.ofwat.gov.uk/wp-content/uploads/2021/05/PR24-and-Beyond-Creating-tomorrow-together.pdf> pp.98)

⁵ CC Water, Blue Marble, ‘Engaging water customers for better consumer and business outcomes, April 2020

with other sources of evidence will be important for PR24 as well as recognition of the difficulty and the novelty of this approach.

We support the adaptive planning approach, this implies a significant focus on the ‘trigger events’ rather than a ‘core pathway’. It would be helpful if Ofwat could give more consideration to and potentially provide guidance on what it considers will constitute a material ‘trigger event’ for consideration in PR24 and how they will be assessed. We support the use of an adaptive planning approach to this work. We understand that this model requires the development of a long-term direction of travel based on setting out a 2050 ambition with customers and stakeholders and working back to plan the steps needed to achieve that ambition. We would use scenario planning/analysis, including the Ofwat scenarios, to understand uncertainty and define a series of ‘low or no regret’ activities or investments that need to be made alongside a series of ‘trigger events’ where we consider that uncertainty will have narrowed sufficiently by a particular point in time to drive a strategic and material choice in relation to the future pathway to achieve the ambition. This approach implies a number of strategic choices with diverging pathways overtime rather than a ‘core pathway’ although we acknowledge that it will be possible and sensible to set out a core pathway. It also implies that there will likely be a significant focus at PR24 on the trigger points, including what constitutes any such point and how Ofwat assessed whether they have been identified and considered appropriately. It may be helpful if Ofwat could give greater consideration to how these will be identified and assessed.

Yours sincerely,



**Director Regulation and Assurance
Northumbrian Water limited**