WONDERFUL ON TAP

# Long term delivery strategy and common reference scenarios

## Severn Trent response

## Executive summary

We welcome the opportunity to comment on your discussion paper on the role of long term delivery strategies and common reference scenarios at PR24. We are supportive of the concept and agree that it could strengthen the link and increase transparency between our long term ambitions and the investments we make each planning period. We also think having a degree of standardisation in the way we stress test our plans to understand how they might stand up to many possible different futures does have benefit for both customers and policy makers by helping companies make more robust business cases, which in turn may give regulators more confidence to approve investments that target longer term service improvements.

We think it is important to reflect the fact that this will be the first time application of a complex framework when deciding how to apply it within in the price review process. We believe the benefits accrue from using it as a tool to better plan and prepare for future uncertainties and share learning across the sector, but think it would not be in customers best interest to set an unrealistically high evidence bar as a reason to defer action. The option to put forward cases for preparatory work is a positive step to enable us to keep future investment choices open but we do not see this as replacement for action even if adaptive pathway analysis is not able to meet the conceptual bar of best practice.

We recognise that you are seeking ideas and comments about how best to integrate the approach into the price review process rather than the concept itself and have structured our comments in the following way:

- Clarifications to avoid unintended consequences.
- Suggestions for integration into the price review process.
- More detailed points of clarity to improve our ability to meet your expectations.

Our main comments relate to issues of comparability across the sector and consistency across the planning requirements that apply to our other statutory duties.

We fully agree that we cannot wait for the draft and then final methodology to be published. We have recently published a consultation on our updated Strategic Direction Statement and are well underway with our customer research and have already initiated the work needed to align our approach to the framework set out in this document. This has two key implications that are important to recognise; (a) Changes that are included in either the draft or final methodology will be difficult to accommodate to the same level of rigour, especially if investment claims will be required in an early submission in Spring 2023; (b) prompt response to the requirements will enable us to share our developments such as tools, visuals, learnings from customer engagement or board involvement, which may be of use when refining your final approach. We feel there is merit in establishing a forum to enable all companies to share their learning in this way.

We do not consider any of the information in this response to be commercially confidential.

# 1.0 Clarifications to avoid unintended consequences

## 1.1 Comparability

In several places the document states that one of the aims is to increase comparability across the sector. Having a standardised approach will improve consistency but we don't think it will yield any information that can be used in a comparative way – particularly around efficiency assessments. It is clear from other areas of the regulatory process, such as reporting on common performance commitments such as mains repairs and sewer collapses, which have been in place for over 20 years, that it takes significant time and resource to reach a high degree of comparability. There are two key reasons why we do not think the information will yield comparative information:

- The methodology recognises the scenarios should include but not be limited to the common reference scenarios. This means each companies' core pathway and cost variance to the low and high scenarios will also include company specific drivers of cost and uncertainty.
- All companies are starting from a different baseline – companies are already operating a different levels of resilience to climate change, or have adopted technology more or less aggressively – so the cost to move to the high (or in some cases move back to the low) will be different for reasons other than efficiency.

We see a clear tension between striving for comparability and enabling companies to own their ambition and strategies. If the data is used mechanistically to challenge company decisions it could create an unintended consequence that plans converge and move away from reflecting customer preferences or company specific risks. Information asymmetry also makes it very difficult to defend our decisions relative to another company without understanding what they have done, where their baseline is compared to ours, what their customers preferences are and none of this information will be available to us before we submit our plans.

For the first application we do not think it is realistic to expect to use this information comparatively in any direct or mechanistic way.

## 1.2 Definition of the core pathway

The descriptions on page 16 and 17 imply the low scenarios will also be lower cost and more likely to be low regret and as such are assumed to be the default scenario. The approach then enables companies to make the case to go beyond the low scenario if the evidence supports it. In reality that is not how our plans will be developed, we consider all options, carry out cost benefit/ total value assessments and then stress test our assumptions to find the most cost beneficial interventions, which may or may not be in line with the low scenario. In cases where the low scenario does not meet the expectations set out in our statutory obligations then it should not be assumed to be the default. The unintended consequence of a preconception that low scenario equals low cost is it creates burden and results in an artificial choice which is likely to create confusion when engaging with customers and stakeholders. It is also important to note that in some cases the low scenario could cost more than a higher scenario depending where our baseline is, but reverting to a lower scenario is unlikely to generate a cost saving because of factors such as write off costs of long life assets.

Our interpretation of your definition of the core pathway is that you expect it to be uniform across our entire plan for any one given service area. This will not be the case, for example all customers already receive different levels of service across many performance areas, such as water pressure, but our performance commitments reflect an average or normalised total service. The draft data tables will expose the planned investment to drive a specific improvement but this may not have a material bearing on the average performance across the entire company. There are two potential unintended consequences:

1. It could undermine the improvements proposed in our plan, because when presented in this way, material enhancement investments don't appear to be driving significant improvement in service. More consideration is needed, including the possibility of also including bespoke performance commitments in the data tables where the common performance commitments do not sufficiently represent the enhancement.
2. It could bias choices towards more binary service improvements where an investment makes a clear step towards a long term objective (e.g. construction of a large water supply scheme) compared to investment based on tackling a series of smaller interventions to reduce high priority risks (such as reducing flood risk).

## 1.3 Definition of the common reference scenarios

We agree that selecting a small number of scenarios with stylised definitions is pragmatic, especially for the first time application. On the basis that we have interpreted the guidance that our core pathway could lie outside the low and high range or be anywhere within it providing we have good evidence to support it, then we are content to retain the low and high definitions as they are presented. However, if we have misunderstood and you are expecting our plan (core pathway) to largely centre around the low scenario then we have four points of concern:

- The low and high scenarios are not equitable across the four categories. For our region the implication is that the default low scenario would drive material environmental enhancements but no or very minor resilience improvements in terms of mitigating and adapting to climate change. This is because the climate change low scenario is extremely conservative whereas the environment low scenario is extremely stretching and would require material investment. This is not congruent with our view of risk or the emerging findings from our customer research.
- In several cases the low and high scenarios do not align with statutory guidelines, particularly WRMP. The most material inconsistencies are in the demand and climate change scenarios. Creating scenarios that require us to stress test a future which does not align with the minimum statutory standard creates unnecessary burden and tension between stakeholders. Specifically:
    - Demand scenario: WRMP guidelines state that water resources should not be a barrier to economic growth and we must adopt the local authority housing growth projections in our core demand forecasting. The low scenario states it should be based on ONS and in some areas there are material differences. This is also creates practical difficulties for our DWMP, for example if the LPA forecast 8000 new homes but ONS suggests they will only build 6000 homes, then how do we decide which 2000 homes not to model in the low scenario?
    - Climate change scenario: The low climate change scenario does not align with any of the climate change scenarios we are required to model within WRMP guidelines and we have concerns about the availability of the data to enable modelling of this scenario.
- Putting aside the misalignment with WRMP guidelines, the climate change low scenario does not represent a realistic long term scenario. In June 2021, the Climate Change Committee published a technical report[1] of the 3rd UK climate change risk assessment, which shows the cumulative emissions associated with RCP4.5 and RCP6.0 are within the range consistent with current policies, and the RCP 8.5 emissions scenario is above the upper end, while RCP2.6 is below the lower end.
- The environment scenario is too narrowly focused on water resources. We understand Ofwat's reluctance to second guess government policy but there is already clear long term direction through the Environment Act that could be used to provide a more balanced scenario.

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[1] Technical report, CCRA (June 2021)

### 1.4 Adaptive pathways

The document states that the adaptive plans will only be triggered at price reviews – for most investment areas we agree that 5 years is an appropriate time period to reflect changes. However we feel this new approach provides an opportunity to consider if there are a small number of areas where it is in customers interest to trigger adaptive pathways in period e.g. where there is urgency for action, where investment spans multiple AMPs or there is a clear disadvantage for delaying a decision.

We think there is a potential for an unintended bias towards smaller, incremental improvements rather than step changes. The implication of figure 2.1 is that incremental investment will always be the least regrets choice. This may be true in some circumstances but part of the aim and original philosophy of long term planning in WRMP was to ensure we are considering all options to find the optimum result to meet the long term supply-demand deficit – this was to encourage companies to compare the costs and benefits for example of a large one off scheme that meets the full deficit but takes 15-20 years and compare it to 100's of smaller interventions done incrementally and delivered each year. A similar philosophy is being addressed in the WINEP reform where we also have examples of inefficient spend due to incremental tightening of standards, that could have been more efficiently achieved had we known the long term standard required. We think it is important that this process doesn't pre-empt the results of our cost benefit and adaptive planning tools.

## 2.0 Suggestions for its application within the price review process

There is already a clear alignment with several of the criteria within the assessment gates used by Ofwat for assessing cost adjustment claims and enhancement deep dives. We believe this is the best way to use any assessment of the quality of our long term strategies or adaptive planning as it removes duplication between tools that might otherwise be created and it also means that the quality of the submission would only be assessed for companies who are proposing material enhancement investment. Ofwat could consider supplementing this with an additional procedural incentive in terms of the level of reporting in period depending on the quality of the case. It would be useful to reflect on the impact of the procedural incentives that formed part of the conditional allowances set at PR19, which included an enhanced regulatory reporting for some companies.

There are several references throughout the document to this approach being a tool to demonstrate efficient costs. It is clear to us how applying this methodology would evidence optimum decision making and sequencing, but it is not clear how that can be used to assess relative efficiency. We think there is merit in exploring how the data could be used to help to build better unit cost models for water resources and possibly for flood resilience. We will develop our thoughts and share them through the cost assessment working group.

We do not think it should be used as a pre-qualifier for fast track status or as an arbitrary cost penalty. Mainly because of the degree of subjectivity and lack of definition of what good looks like. But also because "good" also means fit for purpose – both in terms of the level of investment being justified by the analysis but also in terms of the maturity of any data to enable more robust and complex computational methods.

We think there is a case that this requirement replaces many if not all of the expectations defined in the resilience in the round IAP test and that at the very least any duplication should be removed.

We also think there are further opportunities to use the information that will be generated as a result of this framework to drive greater value for customers. We think the following two areas would benefit from further consideration:

- How to best combine or summarise the outputs to provide a sector wide picture on the elements where there is clear public interest – climate change being the most obvious one, but also long term affordability. This has benefits for water companies in terms of building trust with customers and stakeholders as a whole, but could also support Ofwat in its reporting to parliament on how it is discharging its duties, such as climate change.

- We think an additional benefit of the setting out our long term plan in the context of common reference scenarios is that it may facilitate better discussion about the difficult trade off choices that will inevitably be required to create an affordable plan. There is an opportunity to understand the extent to which those trade offs can be presented at a sector level.

## 3.0 More detailed points of clarity

In this section we identify more detailed points where additional clarity would improve the consistency and quality of the submission we are able to provide.

**Data tables**

- The data tables are not currently split by price control. This may create inconsistency or confusion when mapping to the data tables where costs are split by business unit and price control.
- We would welcome more guidance about how to decouple bioresources particularly in relation to the demand scenarios.
- In LS4 there is no developer services enhancement driver, whilst this aligns with the latest APR guidance and change to the reporting of developer services, we are unclear if this means you want us to exclude any developer services related investment from this analysis.
- It would be useful to understand how you plan to use the annualised costs of each adaptive pathway for each scenario. We are concerned this drives a false level of precision, creates additional burden and we consider 5 year totals for these alternative pathways would be sufficient.
- Is the expectation that companies will add bespoke performance commitments to the data tables if they relate to specific enhancement business cases?

**Overlap with base planning assumptions and other frameworks**

Much will depend on companies' assessment of the performance improvements that they can deliver from base expenditure. This will be affected by assumptions about the level of 'base allowances', the extent of innovation, current performance levels, changing operating conditions and other factors. This may differ legitimately across companies, as will the potential costs of achieving 'enhanced' performance.

It is important that companies have early sight of Ofwat's view of 'what base buys' for the long-term, and to have the opportunity to challenge that view. It is unclear what would happen should a company's view diverge from Ofwat's view on this, with respect to Long Term Delivery Strategies, and companies' ownership of those plans.

Throughout the LTDS document there is reference to DWMP being an existing strategic planning framework and that they have the same maturity as WRMP. DWMP are in their first cycle and so companies are still in the 'learning by doing' stages and so the LTDS requirements need to recognise where DWMP are on their journey in comparison to WRMP. As the underlying ethos of DWMP is working together with other stakeholders and external organisations there needs to be recognition that the deliverability of adaptive plans and investment programmes will be influenced by, and subject to, the ability of others to support a best value core pathway. It would be useful if the draft methodology reflected the differences in the level of maturity of the two frameworks.

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