PR24

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RESPONSE TO OFWAT'S PR24 METHODOLOGY CONSULTATION

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1. KEY MESSAGES

- We welcome the opportunity to respond to Ofwat's draft methodology for the 2024 Price Review (PR24).
- While the water industry has delivered substantial improvements in service since privatisation (at affordable prices), as we head to 2025-30, the industry has never been under so much pressure.
- Statutory requirements from Government and Environmental regulators suggest that PR24 will see the largest investment requirements in a single period since privatisation collide with the greatest cost of living crisis in a generation. Companies, government and regulators need to work together to make sure we can maintain customer trust in the sector and the essential services we deliver. We encourage Ofwat to provide further clarity on the framework for transition funding given the scale of the potential investment required in 2025-30, and to make deliverability and past performance an explicit part of its assessment of plans.
- Ofwat's emerging proposals for PR24 imply further imbalance in the level of risk and return – this is inconsistent with its statutory duties and will not support the substantial investment that is needed at PR24.
  - We are concerned that the proposals will set a series of unrealistic benchmarks for the sector to achieve further damaging public trust. We suggest some changes that would still increase the level of stretch in the package from the status quo but would represent a more realistic and achievable challenge.
  - Ofwat must take reasonable steps to make sure the overall PR24 settlement package represents a 'fair bet' with symmetrical potential for rewards and penalties. Customers are best protected by the continued use of an ex-post mechanism for excluding the impact of extreme weather events.
  - We are disappointed that Ofwat has chosen to reject so comprehensively the findings and conclusions of the Competition and Markets Authority (CMA) following PR19. We provide some further evidence on this.
  - We believe the financial resilience licence modifications Ofwat has separately proposed transfer risk and thus will increase the cost of capital for customers, we will address this in a separate consultation response.
- We welcome changes to better support a long-term focus and propose further improvements to that focus.
  - The scope of the long-term framework should be expanded to make it more comprehensive; a less prescriptive approach will promote innovation and greater long-term certainty can be achieved by committing to regulatory incentives across control periods.
  - We welcome Ofwat's proposals around operational resilience and the desire to establish a common, industry-wide framework for assessing asset health. We look forward to contributing constructively to the development of the new operational resilience work, which will support the development of investment proposals for AMP 8.
  - We support the continuation of the Innovation Fund we now need to build the ecosystem to support innovation.
- The methodology is overly prescriptive, and the role of customers is now very limited. The proposed business plan incentive requires material reform both to address this risk reward balance previously identified, but also to make sure the incentive actually drives companies to develop high quality and well evidenced plans, rather than simply adopting Ofwat's centrally prescribed assumptions. We would like to see a greater role for customers, particularly given the significant trade-offs between service improvement, risk and affordability for the next period.

2. SUMMARY

We welcome the opportunity to respond to Ofwat's draft methodology for the PR24. As we head to 2025-30, the water industry has never been under so much pressure. While the industry has delivered substantial improvements in service since privatisation (by 2025 average water and sewerage bills will have been flat or falling before inflation for 15 years), the external context both in the short and long term have never been more significant.

A **2018 international comparative study** concluded that: "The water sector in England & Wales has outperformed those in France, Ireland, Italy, and Spain since 1990 in terms of the most important service indicators. In five out of the six measures, the water sector is either the top performer or the most improved. In the sixth measure – the quality of sewage treatment – England & Wales is the second-best performer. The water sector in Germany delivers a broadly similar quality service to that of England and Wales. It does so, however, at greater expense. On a like for like basis, prices in Germany are about 12 per cent higher than in England & Wales. There is a strong case for stating that the England & Wales regulated system delivers the best value for money of all the utility sectors in this study. The model has driven up standards and increased efficiency."

However, as we head into the 2025-30 period, we face several significant challenges[1]:

- Customer expectations continue to increase, including in relation to the natural environment, and the industry has been challenged substantially by some stakeholders and in the media for spills in rivers and the sea even during severe storms.
- Climate change continues to impact on the essential services we deliver to our customers and communities. This drives a growing water scarcity problem across the country, which is exacerbated by growth in some areas as well as increasing numbers of extreme weather events with corresponding service disruptions that we need to be resilient to.
- The statutory requirements that water companies must deliver continue to grow with the external pressure driving new obligations around carbon reduction and the journey to Net Zero, network capacity and environmental quality.
- A growing and ageing asset base requires additional investment to maintain and improve service levels and to transform that asset base to one which is more 'nature-based' to reduce carbon and maximise wider public value.
- These challenges need to be addressed while maintaining affordability for customers, not least in the current cost of living crisis. This also requires a continued focus on efficiency and innovation.

This summary sets out the key points of our response to the consultation. Each section of this document then sets out our response to the detailed questions from the methodology consultation. We are happy to discuss these points further, and in more detail, as necessary.

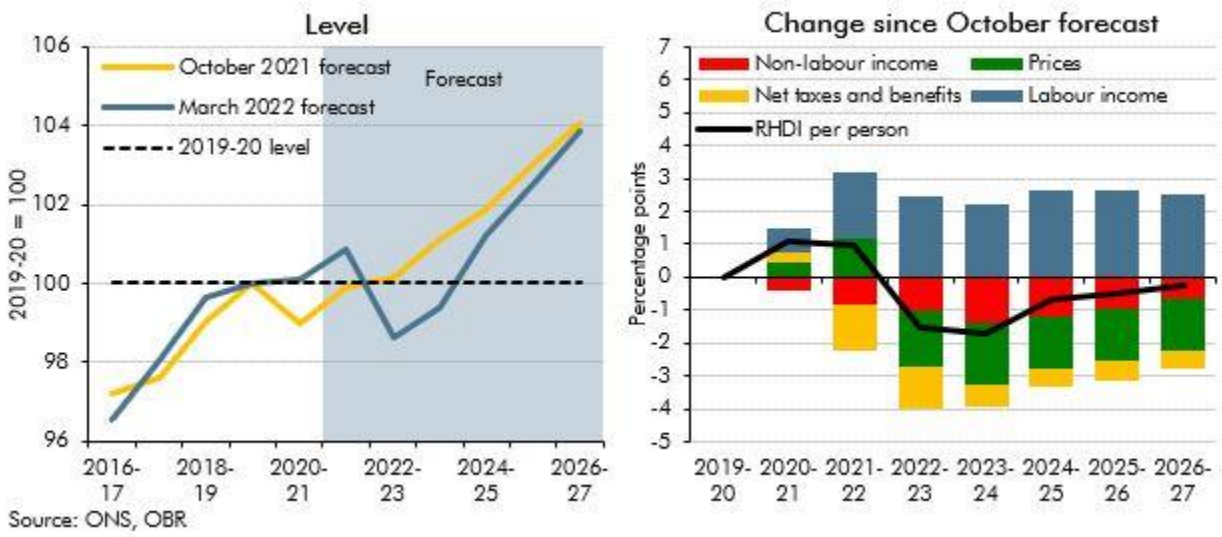
[1] These challenges are summarised at an industry level here: https://www.water.org.uk/water2050/

PR24 will see the largest investment requirements in a single price review collide with the greatest cost of living crisis for a generation. Companies, government, and regulators need to work together to make sure we can maintain customer trust.

We have the lowest combined bills in England and were the first company to set an ambitious goal to eliminate water poverty in our regions by 2030. So far, we are on track to deliver this. However, we know that this is going to become much more difficult. The cost-of-living crisis and high inflation has meant that far more households are seeing a reduction in income coupled with increasing bills. Although bills for our Northumbrian Water region customers are still below 2019/20 bills in nominal terms, this will mean more customers move into water poverty.

In addition to the pressure on water bills, household incomes are falling. The Office for Budget Responsibility (OBR) is forecasting that real household disposable income per person will dip before returning to the long-term trend just after 2026/27, but the change in forecast in just six months shows this is still evolving.

Figure 1: Forecast changes in household disposable incomes



The Resolution Foundation's Living Standards Outlook examines the impact on low-income households. We note that the impact of inflation and energy price increases is greater on our lowest income customers – despite government interventions being worth more in monetary terms for these customers, the overall negative impact is still at least £750 and forecast to grow further. This has a much greater impact on affordability as incomes are low already, and there is often no available income to pay water bills. Changes to interest rates and inflation mean that rents are increasing. Benefits are falling in real terms since 2015. Finally, the Resolution Foundation notes that household incomes will continue to fall for the lowest income customers, even by 2026/27.

At the same time, water customers face pressure on bills from several areas. Companies have recently published their draft DWMP consultations, with very large statutory investments to meet government targets on storm overflows. Across many areas of England and Wales, companies are proposing new investments to ensure security of water supplies – some of which are immediately required to tackle abstraction reductions. The Environment Act introduces prescriptive requirements about improvements on nutrient neutrality. There is an urgent need for water companies to move to Net Zero carbon as soon as possible, particularly given the recent enormous impact of rises in fuel costs and the need to invest in renewable energy.

Many companies are struggling to meet customer expectations and government targets on their networks. Independent estimates suggest that this is likely to require a level of investment of around £80bn[2], albeit this can be phased over the next 25 years, and almost all this investment is being driven by statutory legal requirements on companies.

Our 2025-30 Business Plan will seek to balance these issues for the 2025-30 period to the extent that we can; testing this with customers to understand what they think the right balance of investment versus affordability is. We are concerned that customers might not support some of the statutory targets that are being suggested when the bill impacts are clear to them especially in aggregate. We will challenge ourselves to maximise the scope for innovation and efficiency to deliver all of this for the lowest bills possible and to seek other ways to manage affordability impacts on customers but this is not going to reasonably bridge the gap between affordability and investment given the scale of these requirements.

In addition to the challenges for customer bills, investment plans will be difficult to deliver – both in terms of the capacity to deliver the work, and the nature of this (with a desired material shift away from traditional engineering solutions to more blue/green infrastructure or nature-based solutions). This raises broader questions about the capacity and capability of supply chains to respond to these work programmes, intensified by **concerns from British Water** about the increasing fragility of the supply chain and reducing returns.

We recognise that very few of the investment requirements are being driven by Ofwat and it will principally be for companies to develop plans that they consider are deliverable but would like to work with the Government, Ofwat and the Environment Agency to make sure there is a clear understanding of the risks and challenges for what will likely be a very challenging period. This will mean moving beyond the historical adversarial relationship that has existed between regulators and water companies and should mean all parties – and potentially wider stakeholders - working together to solve the real water crisis that people across the UK are experiencing.

[2] This estimate of c.£80bn is made up of **Government assumptions** for the investment in addressing CSOs (c.£54bn), investment to meet water scarcity challenges which the **NIC estimated** to be around c.£21bn and Net Zero which **Water UK estimates to be** around £4-5bn. This excludes costs for other investments such as meeting nutrient neutrality requirements and asset health.

Because of this uncertainty, there are a range of different business plan outcomes for the 2025-30 period that are credible and there are more difficult trade-offs for customers to consider than ever. Given this pressure we intend to consult widely and robustly with our customers, under the strengthened and independent challenge of the Water Forum, and work hard to understand their preferences. This will include developing a range of business plan options for customers and stakeholders to consider. This will help everyone to understand what can be achieved, and what the impact will be on customer bills.

It would be helpful if Ofwat could:

- Continue to engage constructively with other regulators and the government and support discussions around the right balance of affordability and investment at PR24. We are engaging separately with Defra and other regulators in these discussions.
- Provide further clarity on its views on the balance between customer affordability and investment to meet statutory obligations, to avoid the risk of companies developing business plans that do not meet this balance.
- Provide greater early certainty about the framework for early investment for 2025-30. This would give companies and their supply chains the best chance to respond to the substantial investment proposals by bringing forward sensible and proportionate levels of investment before 2025. Given the scale of the challenge we support two years of transition funding being available rather than one.
- Make sure the deliverability of investment plans and past performance is an explicit part of the business planning process. This could be incorporated into a revised business plan incentive to make sure companies, their Boards and Ofwat more actively consider the deliverability of investment plans (including how they will make sure supply chains have the necessary capability and capacity to deliver these programmes).

Ofwat's emerging proposals for PR24 imply further imbalance in the level of risk and return – this is inconsistent with Ofwat's statutory duties and will not support the investment that is needed at PR24.

In response to earlier Ofwat consultations on PR24, we highlighted the importance of stability and predictability in the regulatory regime given the market volatility and uncertainty given the Covid-19 pandemic, falling returns in the sector and the substantial investment requirements. As these investment requirements become clearer, we are increasingly concerned that Ofwat's PR24 proposals will not support a fair balance of risk and reward.

As David Black highlighted on Radio 4 on 16 August 2022, the sector at present is failing to earn its base allowed return with companies overspending and incurring service penalties. The settlement for PR19 is at best challenging and at worst undeliverable. This was a key reason why the CMA largely supported the appeals made by four companies to the PR19 Final Determinations.

While we accept it is the role of the economic regulator to impose stretch and challenge the sector to do more for less, even as a company operating at or close to the upper quartile on both comparative cost efficiency and service performance, the emerging proposals for PR24 apply an unrealistic challenge. The consultation proposes a range of changes that, in aggregate, increase the risk on companies by creating a 'perfect company' benchmark, which exists only as an academic concept, and that will be too stretching, such that no management team will reasonably be able to deliver against it. It also transfers risk to companies, sometimes for no clear benefit to customers, and ignores the conclusions of the CMA and other regulators in setting the allowed return.

Ofwat sets out indicative Return on Regulatory Equity (RORE) risk ranges in Appendix 10 of the consultation, from -5.00% to +5.25%, suggesting a symmetrical package even with modest upside opportunity. However the analysis is flawed as it uses 2015-20 performance rather than the more recent 2020-22 performance data that reflects the stretching PR19 Final Determination allowances that Ofwat intends to continue to PR24. We have compared this table to the actual 2020-22 RORE values taken from Table 1F of the Annual Performance Report (APR) – and this analysis shows that in practice, the industry ranges from -6.77% to +4.43%, or a significant downside risk. Incentives are thus already skewed to the downside for total expenditures (totex), retail costs, and service performance incentives, even before targets for service levels and base cost allowances are known.

Figure 2: Comparative analysis of notional RoRE using 2020-22 data compared to Ofwat's methodology consultation

Actual returns and notional regulatory equity	Ofwat table 1.1		Actual performance (2020-22 Table 1F)		
Ofwat Table 1.1 v Actual 2020-22	P10	P90	Average	Lowest	Highest
Business Plan incentive	-0.30%	0.30%	0.00%	-0.30%	0.30%
Totex costs	-1.10%	1.10%	-0.21%	-4.81%	1.76%
Retail costs	-0.20%	0.35%	-0.61%	-2.97%	1.43%
ODIs	-2.00%	2.00%	-0.42%	-1.91%	1.50%
Financing	-0.75%	1.05%	-0.11%	-4.79%	2.98%
CMEX & DMEX	-0.60%	0.45%	-0.01%	-0.25%	0.30%
Revenue incentive	-0.05%	0.00%	-0.02%	-0.05%	0.00%
Total	**-5.00%**	**5.25%**	**-1.38%**	**-15.08%**	**8.27%**
Actual best/worst company				**-6.77%**	**4.43%**

Source: Ofwat appendix 10 and NWL analysis of company APRs (2020-22 Table 1F)

The consultation imposes a 'perfect company' benchmark on the industry in several ways[3], for example:

- Setting comparative 'upper quartile' challenges for common PCs has already meant that companies, on average, underperform significantly on them and this is visible in Ofwat's published Service and Delivery reporting. No

[3] See: https://www.ofwat.gov.uk/wp-content/uploads/2021/08/NWL-response-PR24-Consultation.pdf pp.6-7

company performs at the upper quartile in all areas of service, cost, and it is unreasonable to expect that any company can achieve this. In APRs for 2021/22, even the best performing companies forecast substantial underperformance on common PCs. The PR24 consultation expands the number of PCLs set using comparative performance, and so increases the likelihood that all companies will underperform. In some instances, the impacts could be very significant, for example, if Ofwat were to propose a common 'upper quartile' level of performance on reducing CSO spills across the sector, to be delivered from base funding. Based on the cost estimates from the Government's consultation and companies draft DWMPs, this could leave some companies in the sector underfunded to deliver these improvements by hundreds of millions of pounds. Improvements can still be achieved, and at lower risk, using well calibrated targets set with reference to the sectors own historical performance in aggregate.

- Ofwat is right to say that "performance commitments and benchmarks for the notional company should be set at achievable levels and should not knowingly embed asymmetry suggestive of expected penalty or reward". However, the PR24 proposals do not arrive at a symmetric balance of risk and reward that would constitute a 'fair bet'. There are several downside-only adjustment mechanisms, such as the compliance risk index (CRI), and the proposed removal of deadbands on those mechanisms increases the downside risk. There are also multiple asymmetric incentive mechanisms such as D-Mex, BR-Mex and C-Mex (which is symmetric only with the comparative UKCSI position that no company has ever achieved).
- The proposal for separate efficiency challenges on wastewater network plus and bioresources creates a similar problem of trade-offs – companies will need to be at the upper quartile for efficiency in both services simultaneously whilst also performing at the upper quartile on service metrics, lower gearing, etc. For example, companies who improved their efficiency in bioresources would now face a stronger challenge on wastewater network plus. Companies are unlikely to be upper quartile for both, as these services do depend on each other (there are cost substitution effects, as recognised by Ofwat in Appendix 4 and previously by the CMA). Ofwat does not address this problem or assess the impact on risk, other than to say, "we would ensure that the overall efficiency challenge across bioresources and wastewater network plus is appropriate and achievable under our proposed approach."
- The absence of a link to inflation in the household retail price control (despite Ofwat now proposing to include on in the Non-Household retail default tariff price caps) and the lack of clarity on allowances for input cost pressures such as energy costs will further exacerbate cost pressures on companies. Ofwat should consider real price effects (RPEs) carefully and ensure that the link to CPIH inflation is sufficient for input cost pressures given the inability of companies to raise their prices. Currently we see power and chemical costs in particular rising much faster than general inflation and there represent a material part of our operating costs.

We are concerned that the proposals lack an appreciation of the emerging real-world experience of sector performance against the targets set in PR19 and will set a series of unrealistic benchmarks for the sector to achieve which will further damage customer and stakeholder trust. Ofwat should:

- Continue to use reasonable dead-bands at the very least for the compliance-based service performance measures where there are a number of factors, including many outside companies' control, which suggest that paying a penalty for anything less than 100% compliance is unreasonable.
- Consider the impact that the proposed bioresources efficiency challenge will have on sludge trading between companies and the emerging bioresources market and ensure that the efficiency challenge imposed on wastewater is reasonable and achievable in the round.
- Introduce a direct link to inflation in the retail price control, recognising that companies face similar input cost inflation to the general economy. This could use the same CPIH inflation measure as the wholesale price controls.

The above changes alongside other Ofwat proposals will still allow Ofwat to introduce significant further stretch into the PR24 methodology and settlement from where we are but would reflect a more reasonable level of stretch.

At the same time, beyond the setting of unrealistic stretch on service levels and cost efficiency, companies will be subject to other changes which will increase the level of risk, for example:

- Adjustments to the definitions of PCs and ODIs particularly removing extreme weather exceptions will introduce more downside risk, without a corresponding change in expected performance levels.
- The proposed new business plan incentive will introduce a new risk of a downside financial adjustment if companies fail to adopt Ofwat's central planning assumptions because they consider that they are undeliverable. Previous incentives like this have always been asymmetric upside incentives.
- The bioresources control introduced in PR19 assumed zero cost sharing rates, increasing totex risk. This risk is increased by the PR24 proposals to put the post 2020 regulatory capital value (RCV) investment at risk. Indeed Ofwat recognises this increased volume risk[4].

Moreover, outside of PR24, the recent Ofwat financial resilience licence modification proposals set out two licence amendments that could restrict the ability of companies to declare a dividend, even if it was delivering service performance to customers in line with the determination. In our response to that consultation, we will set out how we consider that such restrictions are arbitrary, unevidenced and are not in customers interests. If these changes are taken forward then they cannot be decoupled from PR24, which will need to recognise that they alter the balance of risk and return. Ofwat's statutory duties require it to recognise this. Given the evidence that PR19 incentives are already skewed to the downside, it would be unacceptable for Ofwat to introduce policies that skew this further at PR24, without carefully

[4] Our proposed approach to funding bioresources activities at PR24 (Ofwat, p37)

considering the impact on the ability of companies to finance their functions and the impact this has on the effectiveness of incentives.

On extreme weather exceptions, it is not clear if Ofwat expects water companies to build in resilience to cope with these events (in which case enhancement funding would be needed) to partly tackle this downside risk. We discuss this more in our response to Q5.3. We are undertaking external work with some other companies to examine the best approach to addressing extreme weather risk but the emerging conclusion from that work is that the best approach to protect customers and maintain strong incentives on companies would be an ex-post cost adjustment and exclusion mechanism for service penalties, much like the one Ofwat is proposing to remove for the common interruptions to supply service incentive.

Ofwat must take reasonable steps to make sure the overall PR24 settlement package represents a 'fair bet' with a symmetry of potential rewards and penalties. This is consistent with both its statutory duties and the findings of the recent CMA appeals. We would encourage Ofwat to:

- Continue with and consider expanding the role of exclusions for extreme weather events. These events are clearly not in the control of companies and are becoming more frequent under climate change. Consistent with both the principle of allocating risk to the party best able to manage that risk, and the need to retain strong incentives on companies to maintain service levels to customers, the risk should be shared between companies and customers.
- Significantly amend the proposed business plan incentive so that it actually incentivises companies to develop high quality and well evidenced plans, rather than simply adopting Ofwat's central assumptions and seeking to remove the downside risk that it creates in the overall settlement.

While the use of a notional company can be helpful for normalising industry wide metrics such as gearing and RORE comparisons, it must always be a position that can be achieved by a real efficient company and based on actual performance data. Ofwat will need to assess the overall risk and reward balance at PR24 and, if it identifies asymmetry then it will need to either address that asymmetry at source or make an adjustment to the allowed returns to equity to address it.

As set out above, we remain disappointed that Ofwat continues to reject the vast majority of the findings and conclusions of the CMA following PR19, particularly in relation to setting the allowed return. Instead, Ofwat proposes several changes to the way that the allowed return is set, generally with little or no evidence, that seek to reverse the CMA findings. We have worked with the sector to commission independent evidence on a series of parameters used to set the cost of equity. This further supports the CMA findings in several areas, and we note that in its most recent determination for Heathrow, the Civil Aviation Authority also seeks to adopt and build upon most aspects of the CMA's PR19 redeterminations.

We are disappointed that Ofwat has chosen to reject so comprehensively the findings and conclusions of the Competition and Markets Authority (CMA) following PR19. It has offered little or no new evidence to support those rejections, nor has it really engaged with the evidence and arguments put forward by ourselves and other stakeholders in response to its earlier consultations. We encourage Ofwat to consider the framework and actions recently put forward by the CAA for the H7 price control that acknowledges the CMA PR19 decisions, reflects the evidence and reasonable conclusions reached by that expert panel during the longest and most thorough review of these matters since privatisation, and seeks to evolve and improve on those decisions. We have worked with the sector to provide further evidence for Ofwat to consider in this area.

We welcome changes to the regulatory framework to better support a long-term focus. We propose further steps to enhance that focus.

We agree with Ofwat (and other stakeholders) that economic regulation in the water sector has become focused on the near term. This isn't just an issue for regulators – water companies could also have done more to look longer term, particularly outside of the statutory processes, with long-term planning exercises being insufficiently rigorous in some instances. We therefore welcome the emphasis that Ofwat has placed on long-term delivery strategies and making sure a long-term focus is core to the strategic objectives of PR24. Companies must similarly respond to this challenge.

By 2025 water customers will have enjoyed flat or falling bills before inflation for fifteen years. This is despite the sector recognising the significant challenges of growing water scarcity issues, increasing environmental standards and population growth for many years and increasing its investment. As we approach PR24 the pressure on investment is much larger than in previous price reviews - future investment requirements potentially require a doubling of the industry RCV – and customer bills are likely to rise significantly.

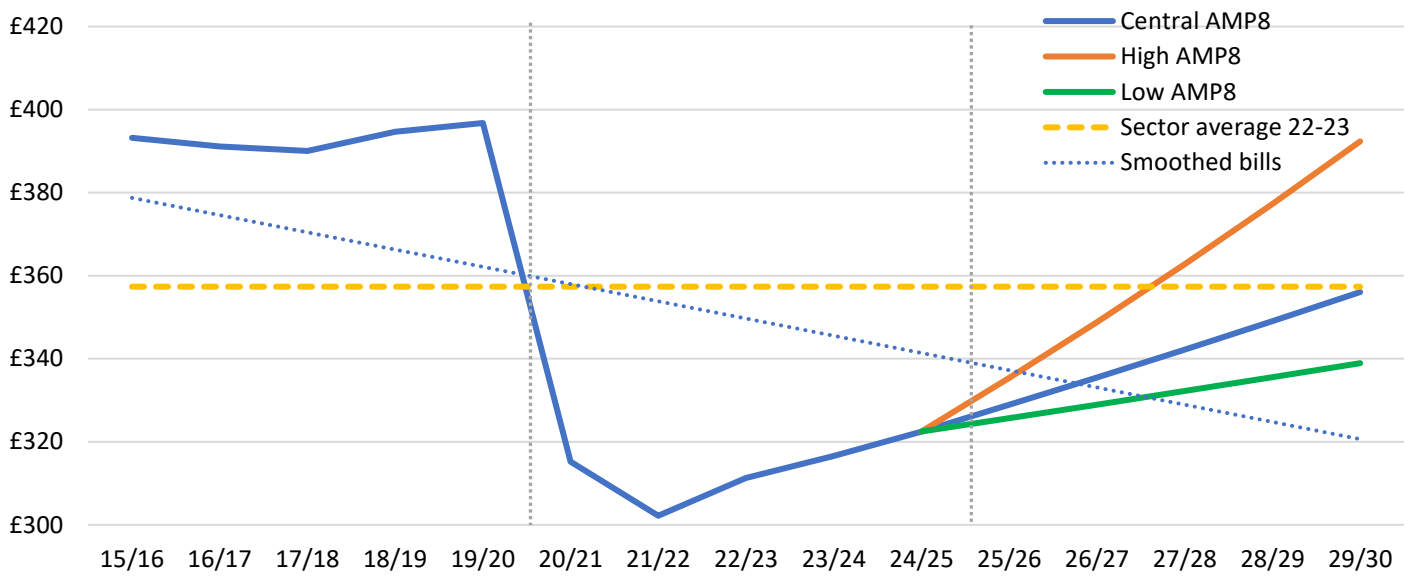
If the sector had been funded to invest consistently from PR09, these bill shocks could have been managed more effectively in line with the stable bill profile that customers support - we illustrate this in Figure 3 below with some stylised analysis of our own position from 2015-30. This figure shows our average bill profile over time from 2015-2025 based on the PR14 and PR19 settlements with some low, medium, and high (entirely) illustrative profiles for the 2025-30 period. We have used some of the early cost estimates we have at this point and the current progress on our long-term plans. We have also provided a trend-line across the period. Two observations can be made from this profile:

- The bill profile is not stable, with substantial reductions in 2020 followed by increases in 2025. This is different from the stable bill profile customers consistently support.
- If the indicative investment requirements for PR19 and PR24 (under the 'medium' scenario for 2025-30) were known at the time of PR14 and included in a sensible and phased long-term plan then we would have been able to reduce

average bills steadily over time before inflation including bill reductions in 2025 (alongside the current cost of living challenges we have).

This chart excludes inflation, which is currently very high. We have been consistently high performers on outcomes and efficiency during this time and our average combined bill is currently the lowest in England.

Figure 3: Illustration of NWL's bill profile from 2015-30 including some stylised future projections and what it could have been if investment had been made on a more long-term basis



Source: NWL analysis

A focus on average bills over successive price reviews has now shifted to a welcome change of focus on addressing environmental improvements and resilience. At the same time the lumpy and delayed investment profile means customers will pay more than they would have done, had we addressed these challenges earlier.

While we support the focus on the long term, we consider that the regulatory framework could go further to better reflect a long-term approach. In particular:

- The scope of the long-term delivery strategies should be expanded to be more comprehensive. Although the decisions around large 'enhancement' investments are particularly important (making sure the right investment is made, at the right time and in the right location) these enhancements currently only account for around 7% of our customer bills. We need long-term plans to be as comprehensive as possible to maximise their value and impact.

- We also recognise that Ofwat may be concerned about such a novel and material change to the regulatory framework, but the guidance is too prescriptive. Ofwat should be less prescriptive about long-term plans, and instead support innovation to allow companies' approaches to evolve and improve through the price review.
- We welcome the certainty around long-term common performance commitments (PCs) – and we encourage Ofwat to set long-term incentive rates across multiple price control periods. As Ofwat has highlighted, customer preferences in the water sector have a degree of consistency over time. Setting consistent incentive rates over multiple periods where these rates demonstrate the appropriate incentive strength will drive change where it reflects customer's willingness to pay and that exceeds the marginal costs of improvement. We note, for example, that the incentive strength around SIM (and now C-MeX) has remained consistent and clear across multiple control periods, encouraging long-term investment to improve customer service performance with substantial benefits to customers.
- Alongside the water sector and other water regulators, we recognise the growing challenge of Asset Health and capital maintenance investment in the sector. We welcome Ofwat's proposals around operational resilience and the desire to establish a common, industry-wide framework for assessing asset management capability (AMMA) and look forward to contributing constructively to the development of the new operational resilience work. Companies will be able to make cases for enhancement investment at PR24 and the consultation sets out a pragmatic and reasonable approach. Ofwat needs to approach these cases with an open mind and recognise the significance of the risks around Asset Health to customers as well as the historical weaknesses of a short-term approach. For future price review periods, Ofwat will need to consider new frameworks for cost assessment including more forward-looking approaches that reflect Asset Health to make sure the efficient amount of capital maintenance investment is supported for customers. This could be signalled at PR24.
- Ofwat could provide long-term guidance on the parameters for the notional company, including gearing. It is not efficient (or easy) for companies to implement large changes in gearing between price reviews, for example, notional gearing has been changed frequently without providing clear evidence why this is appropriate.
- Finally, any long-term assessment in the water sector requires innovation to drive productivity and efficiency given the investment requirements highlighted. We recognise the importance of driving this innovation and have been delighted to welcome Ofwat, other companies and stakeholders (from both inside and outside the water industry) to join us at our annual Innovation Festival. We similarly support Ofwat's innovation fund and are pleased to see the commitment to the continuation of that fund. We do not believe that this issue in driving further innovation and productivity in the sector relates to the scale of funding available - Ofwat has not yet been able to invest the scale of innovation funding agreed at PR19 and there are many other funding sources outside of the sector available too. However, we do consider that we need to evolve the ecosystem to support innovation and productivity across the sector. In our detailed response to the questions, we reflect on how the price control framework might inadvertently constrain innovation, and how Ofwat might address this.

The methodology is overly prescriptive, and the role of customers is now very limited

We will produce a high-quality, ambitious business plan. However, in many areas Ofwat's draft methodology is very prescriptive and requires water companies to use Ofwat figures – and often conflates 'high quality' with 'uses prescribed Ofwat figures.' The most pertinent example of this is the proposed business plan incentive. Under this proposal companies are being strongly incentivised to make sure their plans are focused on service improvements that Ofwat has specified, against targets that they will set, and using incentive rates that they prescribe. Companies will be expected to propose bill levels based on base cost expenditure that are consistent with Ofwat's central view of efficiency costs before enhancement investments. Finally, they are expected to follow Ofwat's view of the allowed return and maintain financial levers within a reasonable range.

While we welcome Ofwat's proposals to allow a two-stage challenge of company business plans and their amendments through open customer forums, the framework implies that customers will only be able to influence what a small handful of 'bespoke' service metrics and any reputational targets that the company wishes to set. The rest will be prescribed through a combination of government and Ofwat targets or central planning assumptions. This provides very limited scope for the Business Plan, which must adopt a very narrow set of parameters or be labelled "inadequate". There appears to be little opportunity to challenge these views or propose an alternative approach.

This could have a major impact on water companies' resilience in the face of climate change and changing weather patterns. There are clearly different needs in different parts of England and Wales – whether we are talking about drought, flooding, or storms. A prescriptive methodology creates barriers for water companies in responding to these challenges, with limited scope to propose investment in this as Ofwat assumes all companies face the same risks.

Further to this, we are concerned that the removal of the initial assessment of plans (IAP) stage means that companies will receive no feedback until draft determinations (DD). We understand and support measures to reduce regulatory burdens, but we see this change as a false economy that would instead lead to more work for both water companies and Ofwat later, as there would be no visibility of any issues or interventions until then.

Ofwat should remove these criteria from the business plan incentives, instead focusing on some of the criteria that either it or other regulators have assessed in previous price reviews. In particular, this should focus on the evidence, quality of thought, engagement with customers and stakeholders about what they want to see in the Business Plan and the rigour and track record of delivery which supports the Business Plan. Otherwise, this is not really an incentive for a high-quality business plan – but a requirement for companies to use the Ofwat prescribed parameters.

We also support retaining a two-stage process. Alternatively, Ofwat could set out an engagement plan, which would discuss its decisions and thinking more openly through the process to DD and allow companies certain targeted opportunities for intervention during this period. This would allow water companies to provide feedback and evidence to support Ofwat in making decisions and understanding the impact of these.

3. REGULATING THROUGH THE PRICE REVIEW

Q2.2: Do you agree that continuing to use our three building blocks helps push companies to meet our ambitions for PR24?

We agree with continuing to use the three building blocks. We have structured our work around outcomes, using customer valuations to inform our planning and decision making. An explicit challenge and calculation of costs and outcomes is a good way to set allowed revenue.

However, we do note that using building blocks risks not considering the three together as a package. At PR19, the links between outcomes and costs were not well defined, and there continues to be a risk that Ofwat could set challenging outcomes without allowing the costs to achieve these. This is particularly a concern when there is increasing investment to hit new and tougher performance commitments – for example, there are different options for storm overflows, and it would not be sensible to set challenging outcomes without allowing the investment required to deliver them.

Similarly, there are some tough cost challenges included in the methodology. The design of the approach to costs and outcomes should be an input to the setting of the level of cost of capital to make sure: the level of return is consistent with the risks (such as shifting weather risk and exclusions to companies); any asymmetry in the ODI package is reflected through an appropriate adjustment; and the overall risk exposure and financing assumptions (including gearing) allow water companies to be financeable and robust to risk events.

In our response to other questions, we have provided evidence that the PR19 targets have proven to be more challenging than Ofwat had estimated. Ofwat could consider a more proactive approach to recruiting more staff with relevant water industry operational expertise, to make sure operational targets are achievable in practice, rather than theoretical desktop calculations. Where Ofwat has done this in the past, this has been effective at setting realistic funding and performance targets – but with increasing use of prescriptive methodology, benchmarking, and econometric models, Ofwat risks further disconnecting from what can be achieved operationally.

Q2:3: Do you agree that we have struck the right balance between what's in and what's outside of the price control?

We support the decision not to change the boundaries of the price controls. We agree with Ofwat's proposals to remove site-specific developer services from wholesale price controls, but we believe that Ofwat should be bolder by excluding all water on-site developer services from the controls, rather than the partial approach as set out. This partial approach would not protect small developments in practice. It would increase administration costs and require new developments to be

split at an arbitrary scale cut off point in a way that is not currently recorded and that developers will not understand. See 3.2 & 3.4 for more details.

Under the options for developer services, Ofwat says that even under the options for excluding these from the network plus price control, they would "review costs at the price review and monitor costs and revenue annually through the APR". If the costs are reviewed and monitored – and presumably, Ofwat would act if they were not content – then this could become a de facto price control in any case. Ofwat should be clear on how it intends to regulate this, including its purpose for collecting information about forecast costs at the price review and actuals in the APR. For example, it would be reasonable that this might inform reviews of the charging rules for these services, support a competition review, or support negotiated settlements. Setting out the purpose is important.

Finally, we believe there is an opportunity to de-regulate third party services provision. We give more details in Q6.2.

Q2.4: Do you have any comments on our approach to evaluating progress? What specific evaluation questions (based within the four key ambitions) do you think an evaluation should look to answer?

We welcome Ofwat discussing how it will evaluate the impact of this price review at the methodology consultation stage – this is an important part of its obligations as a public sector body, and customers across England and Wales (as well as water companies) should rightly expect Ofwat to reflect on this. We also welcome the publication of a summary of the impacts of Ofwat's key proposals for PR24 alongside the final methodology, though we are disappointed that this was not included alongside the consultation to help respondents make their assessment.

Ofwat could consider an evaluation framework from the outset by setting out a series of reflections for each policy. For example:

- What outcomes do we expect this policy to achieve?
- Who will change their behaviour because of this policy, and can we quantify this? What is the policy chain from inputs to impacts?
- What costs does this place on water companies and other stakeholders? What benefit(s) is this expected to have for customers, the environment, and wider society? Is this policy the best-value decision?
- What are the unintended consequences of this policy? (What can be foreseen now, and what can we measure later?)

In general, although Ofwat considers factors such as complexity and burden when considering options, this is not structured and there is not much evidence of quantifying the costs and benefits or considering the impact this would then have on the behaviour of individuals. This could be improved for the final methodology.

There might also be a challenge in separating the impact of Ofwat's activities from those of other parties – including water companies and other regulators. In its annual report in 2021, Ofwat summarised the water sector's performance and described the activities it had carried out to contribute to these. However, it was not always able to describe the link between its actions and the impact this might have had on the performance of the sector or show the evidence that this did make a difference in practice. Some of the activities did likely have a major impact, for example, the quick response in the retail market for Covid-19 likely avoided some serious impacts for business customers, and Ofwat should rightly be proud of this success. For other areas, such as storm overflows, it is difficult to understand what Ofwat's objectives were in this space, how it went about meeting them, and how successful it was.

Ofwat should also challenge itself on requesting information, where we sometimes see large data collections with short deadlines. Sometimes this is unavoidable, but often this is requested without an accompanying description of what Ofwat will do with the data, and the potential benefits for customers that would justify the costs of diverting resources from other priorities. This can risk undermining incentives and weaken our ability to plan our response, leading to lower quality information. A large increase in data requests over the last few price reviews does not support the simplification of price reviews, or ownership for companies.

Finally, any evaluation of outcomes or progress should be carried out by an external, independent party, in line with best practice.

Affordability

We were disappointed by the list of PR24 policies to support affordability (Table 3.1 of Appendix 1). For the most part, these are about reducing costs through efficiency and innovation – these are worthwhile but would be part of the price control framework regardless of the context and challenges.

The consultation does not acknowledge the potential conflict between customer views and statutory requirements, and Ofwat's new approaches will not strengthen the customer role in the process. At PR19, Ofwat chose to override customer views on acceptability for most water company plans. If this were repeated at PR24, then customers would rightly be disappointed that their views were sought and then disregarded – particularly when this balance is more difficult.

Long-term delivery strategies can be very helpful in considering affordability, and we welcome the inclusion of this in the list of policies to support affordability. Where Ofwat intervenes in water company plans – particularly when challenging the need for enhancement expenditure – it would be good to also demonstrate the impact on the long-term bill profile, explain how Ofwat expects this to affect the core long-term pathway, and how deferred investment will impact customer bills in the future. Ofwat's approach to considering long-term bills was not sufficient at PR19.

4. DESIGN AND IMPLEMENTATION OF PRICE CONTROLS

Q3.1. Do you agree that in our final methodology we should commit to introducing either an adapted water trading incentive or a new water trading incentive at PR29?

We broadly agree with Ofwat's proposals. Water companies do already have a motivation to trade, even without the incentive. Under our Water Resource Management Plan (WRMP) process, we assess options including bulk supplies for the best value – there is an objective process for selecting when bulk supplies are the appropriate option. We engage with other companies about the scope for us providing them with bulk supplies, and these discussions have been further facilitated by regional water resources groups. Ofwat could consider removing the incentive entirely, as water companies can include incentives within their commercial negotiation.

We agree with changing the point of approval of a trade as a qualifying trade, and this is a welcome change. We do not see the benefit in calculating and claiming this annually, as our bulk supplies are mostly long-term in nature. We also note that some bulk charges are "reservation charges" which might not be used every year, but these costs are still beneficial for customers because this provides resilience in case of drought. Using actual traded volumes would not account for reservation charges.

We welcome Ofwat not removing the ability for companies to simultaneously benefit from both import and export incentives. We have three regions with no means of interconnection, and very different profiles of surplus and deficit.

Option 2 is unnecessarily complicated, and the benefits are not articulated. If Ofwat felt that it needed to be more closely involved in the pricing of bulk supplies, this would be better done through charging rules around bulk supplies rather than as part of a price review incentive.

Water trading incentives don't currently apply to increases in existing bulk supplies. These should be recognised as deals that are beneficial to customers, rather than only including new trades where new infrastructure is built. An incentive that requires new pipes to be laid to qualify rather than using existing ones could result in unnecessary investment that is wasteful for all parties.

We welcome Ofwat's proposals to defer the work on water resource bilateral markets and to remove the requirement for risk sharing arrangements for large water resource assets. These two mechanisms added no value for customers and simply increased perceived risk for water resource investment. The bidding market, along with the required consultation process and options appraisal in the WRMP are much more effective ways of making sure all options are considered, while not adding risk to committed investment.

Q3.2. Do you agree with our proposals to: a) Continue to include network reinforcement in the network plus price controls? b) Remove wastewater site-specific developer services from the wholesale wastewater network plus price control?

Including network reinforcement in the network plus price controls

We agree that network reinforcement should be included in the network plus price controls, and wastewater site-specific developer services should be removed from the wholesale wastewater network plus price control. These were included in price controls for the first time at PR14 to accommodate possible changes to charging rules about the balance between ongoing and developer charges, but this is now stable.

Removal of site-specific developer services from the water and wastewater price controls

We agree with Ofwat's observations that the inclusion of developer services in the network plus controls causes volatility in water bills. It also creates a disincentive for companies to support complex large non-household developments where the larger connection costs are not fully reimbursed by the Developer Services Revenue Adjustment mechanism (DSRA). Such developments are self-funding and are best excluded.

We agree that nearly all wastewater site-specific developer services are delivered by self-lay providers (SLPs) or developers. For water, the proportion of connections delivered by SLPs/ new appointments and variations (NAVs) is increasing annually (40% for 21/22).

Q3.3 Do you agree that the inclusion of network reinforcement in cost sharing would be enough to manage uncertainty around the volume and mix of network reinforcement work to be delivered?

We do not agree that cost sharing is sufficient, as it would still leave companies with a disincentive to support developments that require network reinforcements.

The volume of new properties connected is not in the control of water companies and the DSRA was set to include network reinforcement costs to adjust for variations from the central forecast. We remind Ofwat that the DSRA is necessary to adjust for the additional costs of new development as the additional revenues from infrastructure charges are absorbed within a fixed revenue control.

Whilst the DSRA values can be reduced once site-specific costs are excluded, there are still off-site network costs that will be affected should housing volumes change. With infrastructure charges matching network costs and still being part of the fixed revenue control, there needs to be an offsetting adjustment for the additional costs to make sure companies are not

disincentivised to provide network reinforcements. Also, should housing developments be less than forecast, the DSRA will return funding to customers for forecast network reinforcement that is no longer necessary.

We do not believe that adjusting for the mix of reinforcement work is necessary or practical.

Q3.4. Excluding new developments of more than 25 properties

All water site-specific new developments, including those with fewer than 25 properties, should be excluded from the price controls. These were not included in the price controls until 2015, and that site-specific charges are limited to being set at no higher and no lower than our costs. They are effectively regulated by the cost reflective charging rules for new connections, and competition law.

Including these in the price controls does not provide any protection for small developments in practice, as the price control does not restrict connection charges in any way; nor can Ofwat introduce limits on developer charges as part of PR24 determinations. Under the Competition Act, companies could not charge small developers less than their actual costs, even were Ofwat to try to 'protect' these customers by applying a cap.

Ofwat's rules on connection charges protect these customers from potential monopoly power, by setting how monopoly companies must charge customers. Charging rules have an important role in Ofwat's regulatory tools, allowing Ofwat to set restrictions on how companies determine how different groups of customers should be charged. These rules are the appropriate mechanism for regulating site specific developer charges, rather than using price controls set at PR24.

Q3.5. Do you agree with our proposals on direct procurement for customers (DPC)?

We agree that DPCs are likely to need to be £200m of totex to be cost beneficial. The threshold should focus on capex (as savings for customers are likely to be focused here), where at least £100m is needed for this to be cost beneficial. £200m should not be a hard constraint, and Ofwat could consider developing a framework of principles for assessing this instead.

Ofgem has a threshold of £100m capex and published its own cost-benefit analysis (CBA) model. For water, there are a few models that have been developed by third parties and used by water companies but they are not consistent and will drive different outcomes based on the assumptions used – Ofwat should develop and publish a common framework and model for cost-benefit analysis.

We can already see that investment plans for 2025-30 are likely to be much higher across the sector and delivering a capital programme of this scale could be extremely difficult. In this context, broadening the scope for market solutions

should be encouraged. This could include alternative methods for other parties to support delivery of the capital programme, including for example separate ownership of assets across a water company area (that is, not just single large schemes).

3.6. Do you have any views on any other aspect of our proposals?

We do not agree with Ofwat's proposed "no automatic indexation of allowed revenues" in the retail control – Ofwat does not explain why this would provide appropriate incentives for retailers to manage input costs or consider the consequences of this under different scenarios. There is an arbitrary distinction between wholesale costs (inflation less efficiency challenge: upper quartile challenge plus frontier challenge) and retail costs (which effectively starts from the assumption that efficiencies can match inflation pressures, whatever that happens to be).

The alternative use of input price pressures requires the regulator to predict inflation for the five-year period, with no adjustment mechanism should actual inflation vary from the levels used when assessing input price pressures. Recent experience provides a good case in point for the difficulty of doing this.

To date (2020-22), 14 out of 17 companies are overspending the PR19 cost allowance (APR Table 2C lines 30-31), by 21% overall. This overspend is likely to increase in future years as costs increase, yet the allowances remain fixed.

Most retail costs are for wages and doubtful debts. If inflation were higher than expected, employees would reasonably expect to see their wages increase with inflation to stay constant in real terms. Employers can manage this by not giving such pay increases, but would become uncompetitive in the job market – this is not an efficient outcome. There is no reason that a higher inflation environment should lead to more efficiencies in this area.

We would like to understand how Ofwat expects companies to manage input price pressure on wages if inflation were higher than expected, and why it thinks this would be an efficient strategy in the round.

For doubtful debts, Ofwat uses average bills as a driver for estimating costs. Average wholesale charges are indexed to inflation, so these costs would increase. We would like to understand how Ofwat would expect companies to manage input price pressure on bad debt, if inflation were higher than expected, and why it thinks this would be an efficient strategy.

We should also consider what would happen if inflation were lower than forecast at the price review – this is a plausible scenario, which happened at PR09. Companies would collect more revenue from customers than intended, without increasing their efficiency or productivity to do so – this is not a reasonable outcome for customers.

Ofwat should index retail price controls to the Consumer Prices Index including owner occupiers' housing costs (CPIH) inflation. The proposed approach creates unintended consequences in the form of perverse incentives for inefficient outcomes in the job market, and unreasonable treatment of customers with bad debt. Ofwat should explain its thinking more thoroughly, including the outcome it expects to achieve and how this policy will change behaviours accordingly, in the circumstances of lower or higher inflation than forecast at the price review. Ofwat should assess the impact of the PR19 policy, which is currently creating perverse incentives, before settling on this again for PR24.

Finally, we note that in the September 22 **Non-household (NHH) REC review**, Ofwat proposes an explicit allowance for CPIH indexation of Non-Household retail costs:

5.6 Indexation for inflation

The current REC price cap for Group One customers specifies the maximum charge to a customer in terms of wholesale charge plus an allowed average retail cost component, with an allowed Net Margin applied to both elements. The REC further specifies that the ***allowed retail cost component for the relevant year be adjusted each year, with the adjustment given as the CPIH inflation rate as measured in October of the previous year.***

We question how Ofwat can justify a differential regulatory policy between the two retail controls.

Revenue forecasting incentive (RFI)

An RFI incentive isn't necessary. It would be simpler for Ofwat to require companies to meet their existing licence conditions on revenue controls. A financial incentive introduces additional forecasting risk without being clear why the existing licence condition doesn't provide sufficient protection for customers on this (noting that customers would pay only the allowed revenue, in the long term, so there doesn't immediately appear to be an incentive for companies to deliberately manipulate this). We note that Ofwat's evidence in Appendix 10 shows that a penalty has been applied in around 30% of cases between 2015-20, many of which have been from variations above the maximum penalty rate. This distribution suggests that forecasting error is likely to be random rather than systematic, and so is likely to relate more to the inability to accurately forecast weather in advance. This suggests this penalty is not well targeted, and there is no evidence it has any benefit to customers. This also acts as a barrier to innovative tariffs, where these seek to incentivise reductions in demand, by introducing increased forecasting risk.

In addition, the RFI includes a financing adjustment in addition to the forecasting penalty. The PR19 methodology explains that this mechanism was introduced because there is an opportunity for companies to gain "around 0.9% on RORE" – but this appears to be already adjusted out through the financing adjustment. The penalty mechanism is therefore addressing a risk which is already adjusted for.

5. CUSTOMER ENGAGEMENT

Q4.1. Do you agree with our approach to making sure that companies' price review submissions and our determinations reflect an understanding of customers', communities' and environmental concerns?

We do not agree with Ofwat's approach. As set out in previous consultation responses, companies should own the relationship with their customers, and as a result are best placed to engage them on such matters. However, while this remains our view, we want to be constructive in the development of the approach that will be an important component of PR24.

We had concerns with the methodology for the central Ofwat/CCWater outcome delivery incentive (ODI) research, which we set out in our response to Ofwat's consultation in February. We do not repeat these concerns here but note that they have not all been fully addressed. Ofwat published its response to the **Ofwat ODI Research Peer Review** that we provided in April 2022 (along with three other companies) on 5 September, too late for us to review fully for this consultation response.

In the methodology consultation, Ofwat sets out its approach to setting performance commitment levels (PCLs). At the same time, we need to make sure that customers can influence the plan in a meaningful way. There is a risk that customer views about their priorities and level of ambition could be overridden by Ofwat's challenges on PCLs. Customer views about affordability and acceptability could be overridden by Ofwat's views on costs, potentially ruling out investment that customers value.

At PR19 and PR14, Ofwat got this balance wrong – our statement of case submitted to the CMA noted PR19's focus on short-term bill reductions over other customer priorities that are equally relevant (such as resilience). The **Water Forum's response to Ofwat's draft determinations** set out its concerns that customers wanted cost savings reinvested in enhancement projects that would improve resilience, rather than in a bill reduction beyond that which they gave support for. Customers were concerned that short-term bill reductions could lead to higher risk exposure, more unplanned costs, and hence longer-term bill increases. This was a clear, well considered, independent view.

This could be much riskier for customers at PR24, where Ofwat proposes much more centralised control over setting PCLs and costs. Ofwat could do more to explain how it will take the views of customers into account when setting PCLs, and there is no evidence of customer views provided when discussing common performance levels, or how PCLs will be set (other than to note that long-term delivery strategies and customer views "also feed into setting PCLs").

Finally, we are pleased to see that Ofwat states that it "wants [its] price review decisions to be better informed by the views of customers and communities". However, it is not clear how it will include this in its decision making throughout the process.

Q4.2. Do you agree with our proposal to conduct open challenge sessions?

We agree with the principle of open challenge sessions – and we support any opportunity for customers and other stakeholders to challenge us on our plans directly. We consider that the Water Forum has been able to challenge us independently, but a wider challenge is always welcome. Ofwat should clarify if these sessions are for customers, or customer representatives – depending on the level of expertise and direct experience that are required. We think customers may feel unable to express their view as readily if customer representatives are present.

We would like to work with Ofwat to develop the details for these sessions, and have a few initial ideas:

- Any specific requirements for these need to be agreed quickly – before the publication of the methodology in December. This would allow us to build this into the timetable at the appropriate time to present well-developed proposals, while having sufficient time to reflect any revisions to our plans.

- Ofwat says it "may prescribe the nature of content" of presentations on our draft Business Plan – it is difficult to comment on the effectiveness of these sessions without knowing what this would be. For example, there will be limited scope to reopen consultations on some of the long-term planning frameworks such as WRMP, Drainage and Wastewater Management Plan (DWMP), or water industry national environment programme (WINEP) at this stage. It is worth being specific about what can and cannot change as a result of these sessions, so that we can focus attention on the areas where these sessions can have most impact.

- A short presentation could lead to views from the audience being distorted by the quality of the presentation, rather than the substance of the plan. Unlike using deliberative panels over time throughout the whole development of the plan, any new attendees would be expected to react immediately. The sessions should be designed carefully to ensure that the input can be effective and robust, it can to some extent shape final plans and drive innovative ideas and new perspectives. The focus of these sessions on solving the tough problem of balancing investment for improved service or reduced risk with affordability.

- These sessions would ideally have an independent chair, preferably someone involved in challenging the company throughout the business planning process who is familiar with the sector and the challenges and ideally the development of the plan to date. This person should understand the stakeholders and the key issues in much more depth.

- Ofwat should think about how these sessions will be used in its framework to assess company business plans. In particular, the weight placed on the session after the final Business Plan is submitted must surely be minimal compared to working with stakeholders and customers throughout the plan development process, and demonstrating how their views have been taken into account. There is a risk that this session distorts the assessment.

- While these sessions have a purpose in providing feedback and challenge to us on our draft plan (where breadth of views is critical), we don't think these necessarily have a purpose in measuring objectively how well our customers and stakeholders support our Business Plan. It would be good to be clear about the objective of the sessions, as these could be quite different depending on the purpose.

Some customer perceptions will change over time, and there is a risk that customers do not get much chance to give their view on Ofwat's decisions (the determinations, by their nature, are not customer facing documents). It would be good to reflect on how these sessions could seek to reflect these changes over time, for example to test that customer views from 2022 and 2023 are still relevant by final determinations in 2024. For the second challenge session, we therefore propose an alternative approach. Perhaps the appropriate time for this session is to test customer and stakeholder views on the draft determinations in 2024 – with Ofwat presenting their interventions and reasoning and seeking views from customers and stakeholders on whether these are appropriate interventions to make. This would allow Ofwat to directly address some of the challenges from PR24 (for example, where customers had preferred to invest more into resilience rather than having their water bill reduced further than the business plan). Ofwat could explain how it had considered views from customers and stakeholders in the challenge session in its final determination.

6. OUTCOMES

Q5.1. Do you agree with our proposed package of common performance commitments (PCs)?

We do not agree with the whole proposed package of common performance commitments (see our detailed response to questions throughout this section). We are pleased to see Ofwat adopting some of our bespoke PCs from PR19 (such as on emissions). We would like to see evidence that the package of common PCs covers the right things for customers across the sector, and that there are no other important priorities that might be neglected with a focus on these specific PCs.

Water demand

In our response to the outcomes consultation in January 2022, we said that although using a distribution input measure is simple and incentivises the right behaviour, it means that demand risk would sit entirely with the water industry. There are some advantages to such a measure - we note that a single measure would allow companies to select the methods which are most appropriate to their areas, considering the best value for customers. For example, in our Essex and Suffolk areas we forecast that we will need to make substantial demand reductions – but leakage is already low and improving this further has a higher marginal cost. Conversely, in our North East region, water demand reductions are likely to be less critical as we have a water surplus – but leakage is relatively high (while still below the sector average), and so we could focus more on this. We support the Environment Act demand targets, and this should translate into action for water companies (among many others).

However, water companies are only able to control part of the picture on water efficiency, with the long-term target very dependent on the strength of the government response and wider societal attitudes. We acknowledge that this is the case for many other PCs too but note that companies could end up with large over-performance payments, even if they are not responsible for reducing water consumption (or alternatively large under-performance penalties if the government does not achieve their objectives). Ofwat recognises this in the inclusion of water efficiency in the long-term delivery strategy growth scenarios, but it will be important to set out the assumptions in setting PCs for demand – and to consider how this might need to change in future. The response to Covid-19 in the 2020-25 period has shown the potential magnitude of the impact from external factors even in the short-term. For business demand, these challenges are much greater.

Leakage and per capita consumption (PCC) are both well-established measures, with clear definitions and performance history. So, despite the weaknesses in PCC, we support the continuation of separate measures for leakage and PCC for PR24.

Using deadbands for PCC would reflect that this risk is mostly outside our control – alternatively, the incentive through the ODI could be weakened. This is a two-sided risk for customers, too, as we could see large reductions in PCC if the government acts on water fittings and standards.

However, ODIs are not the only approach that can be used to fund and drive reductions in household and business demand. Instead, Ofwat could ask water companies to propose programmes for tackling water efficiency, applying a price control deliverable (PCD) to this expenditure if this is not spent. This would reflect the fact that companies only have a limited impact and responsibility in this area, and so they (and water customers) should not be exposed to the full outcome through the ODI.

Business demand is much more difficult than PCC, with businesses having a wide range of demand profiles, and wholesalers having more limited responsibility and opportunity to influence their demand. Any measure of business demand must exclude the demand effects of new customers, as water companies should not be penalised for supporting new investment in their areas. Some areas will likely see growth in business demand, even if the individual businesses become more water efficient.

Ofwat could address this area through allowing enhancement expenditure based on 1) creating better incentives and structure for water efficiency through smart metering for NHH; 2) wholesalers directly taking responsibility for water efficiency for schools and community organisations (who cannot necessarily respond to these incentives by investing to reduce their consumption). There is no clear need for a PC and ODI here, with companies having even less influence over business demand and no obvious solution to measuring growth (which for households, is neatly included within the PCC measure). If necessary, this could include a PCD based on implementing a set number of measures (such as meter installations) or a specific Ml/day reduction based on the expected savings from measures installed.

In our January 2022 response, we said that we supported including small business users within PCC. Business retailers are more directly able to promote efficient use of water by their customers, but so far this has not had much impact (although many retailers offer this service to NHH customers, take-up has been low, and the efficiency savings are estimated to be only 0.3% of consumption across the three largest retailers). The Retailer-Wholesaler Group Water Efficiency Subgroup (**RWG WESG**) noted that customer willingness to pay (WTP) is below the efficient cost to supply these services, and so market participants would require funding and incentives amounting to at least £22m per annum to achieve this.

The RWG WESG report does not provide any evidence that the issue is that WTP is lower than the efficient cost to supply, but states that the absence of take-up must mean that this is the case. For commercial organisations, the benefits from water efficiency would be shared between the customer, the retailer, and the wider community (through avoiding future new supplies). Water retailers and customers don't have any incentive to create the share of the benefits for the

wider community, and this likely contributes to the low take-up of water efficiency. We also note that self-supply customers have made significantly larger reductions in consumption (around 4% in 2020/21, according to Ofwat's state of the market report).

We do not agree that this necessarily means wholesalers should lead the approach. Wholesalers do not have customer details, and nor do they have a relationship with the customer in the same way that they do with household customers. This is fundamental to delivering water efficiency. The RWG WESG notes that wholesalers are best placed to carry out physical interventions, such as fixing meters, but that this has a very small impact on water efficiency (and should be done anyway).

A shared approach might be the best option, with wholesalers committing to actions on NHH metering (with funding for this allowed at PR24 based on retailer views) and retailers receiving a higher retail margin to allow them to make water efficiency improvements. We would like to be able to install smart meters for NHH, and we would like to see the Ofwat methodology support the inclusion of this sort of investment in business plans where it is supported by retailers. At PR19, this was not covered by any enhancement expenditure or ODIs (as water efficiency for NHH was assumed to be part of the NHH retail market).

We also note that NHHs are not all the same. As part of our work on water efficiency for households (HH), we work closely with schools and community organisations on education and targeting. The benefits from water efficiency improvements for these organisations would directly return to the schools and community organisations through reduced bills, and so to individuals and families through improved services – and so all the benefits accrue to local communities. Water companies could take direct action to install water saving measures for these organisations (such as rainwater harvesting or greywater recycling) if there were sufficient funding available to do so through enhancement and/or ODI over-performance. These organisations could be brought into scope for demand reduction targets for wholesalers.

We welcome the willingness from Ofwat to engage with how the wholesale charging rules could support innovative approaches to tariffs. This could create opportunities to work with retailers to incentivise water efficiency, providing a greater incentive to provide these services. However, it would be difficult to introduce tariffs where community organisations cannot afford to take measures to reduce their water bills – as some water companies experienced with the introduction of area-based surface water drainage charges. If companies were able to directly provide water saving measures for community organisations and schools, this could mitigate this.

Leakage

The National Infrastructure Commission (NIC) **challenged the water sector to reduce leakage** by 50% from 2018 levels by 2050. This target could be shared across the sector in three possible ways:

- Every company has an equal target of 50% reduction from 2018 levels, as set out in the methodology consultation.
- Ofwat sets targets according to how well companies are already doing on leakage, with the sector reaching a common level of absolute performance in 2050. For example, if the sector average were 100 litres/property/day, then a company whose current performance is 75 l/p/d would have a target to reduce by 33% - but a company whose current performance is 120 l/p/d would have a target to reduce leakage by 58% by 2050.
- Ofwat divides the 50% reduction target according to the economic level of leakage (ELL) in each area. That is, companies would not use the ELL as a constraint for further improvement (as in historical price reviews), but as a guide to the value of leakage reductions, ensuring that reductions happen where there is most value to be gained for customers and the environment. This is our preferred option.

Option 1 has the advantage of simplicity, but this would be more difficult for efficient companies (and would reward companies who were inefficient to begin with). Option 2 is only slightly more complicated and could be calculated with current data. This would set a "catch up" challenge on leakage, bringing the sector to a similar level of performance by 2050.

Option 3 would help to target leakage reductions where these have the best value for customers – for example, setting higher targets in areas where there are big demand reductions needed to meet future demand for water; and/or where leakage is cheaper to tackle. It would be extremely difficult for Ofwat to estimate a best value approach to tackling leakage across the sector but using the economic level of leakage as a proxy for allocating targets could achieve a similar aim.

Ofwat describes its initial econometric modelling exercise to identify the efficient level of PCC for each company, and states that pre-pandemic numbers will be used. Including 2021/22 will not exclude the impact of the pandemic entirely, as patterns of demand have shifted in response. However, this illustrates the potential advantage of considering leakage and demand reductions together. We welcome the proposal that metering will be considered in setting PCC targets – we have a low level of metering at the moment in our North East region, and this area remains not "seriously water stressed" for metering in the **2021 determination**. There are wider benefits in installing smart meters to detect leaks (as this can enable the use of digital twins and modelling to identify customer supply pipe leaks), and we would like to see the government's position change to allow universal smart metering in the North East in future.

Q5.2. Do you agree with our proposed guidance for bespoke performance commitments?

We do not agree with the proposed guidance. At an industry level, we agree that bespoke PCs have not always proven beneficial for customers – and across the sector, rewards have been higher on bespoke PCs than on common PCs. A relatively small number of companies and individual bespoke PCs have a disproportionate impact on this position (for

example, Severn Trent's sewer blockages PC led to an outperformance payment of £32m in 2020/21 alone, compared to underperformance payments across the sector of £117m for common performance commitments). While some bespoke PCs have provided big rewards for companies whilst not delivering frontier levels of service, others are stretching and in line with customer preferences.

During the preparation of our Business Plan for PR19, the Water Forum challenged us to set and deliver stretching bespoke PCs – these included for example:

- Setting a supply interruptions target to reduce interruptions in the 1-3 hour range, where we have historically been an industry leader, deliberately more stretching than the standard common metric of 3hrs.
- Setting a target on sewer flooding, an area where our performance has been comparatively weaker, to reduce the number of repeat flooding events again to better protect customers from this significant service failure.
- Being the first company to set out proposals to eradicate water poverty by 2030 - something which has now been adopted more widely.

Our bespoke supply interruptions and sewer flooding PCs are financial incentives (in 2021/22, we estimate that we will receive a £1m underperformance penalty for these, despite improving our external sewer flooding by 12% last year). Our water poverty PC is non-financial. It is difficult to see why these should be removed if customers still support them – they are stretching, provide an incentive to improve, and at PR19 reflected the service outcomes customers wanted and were willing to pay for. We introduced our PC to reduce interruptions in the 1-3 hour range in response to challenge from the Water Forum, and the proposed common PC does not reflect this challenge – we suggest that a change to the common PC (such as setting this at interruptions more than two hours, rather than three) would help to address this concern.

At the same time, these bespoke PCs have helped to make sure new innovative and stretching PCs can now be set for the whole sector - for example, some of Ofwat's new 'common' PCs for 2025-30 are based on bespoke PCs we set at PR19 (such as for greenhouse gas emissions).

However, none of our current bespoke PCs reflect local circumstances that do not apply to most other companies, nor are they clearly in areas where we provide poor service on a common issue. They would not obviously be eligible for the very limited number of (around three) bespoke PCs that Ofwat is proposing to allow at PR24.

We do agree that there are too many PCs, with different definitions and with different levels of stretch. Rationalising the number of PCs is a good way of retaining management focus on the right things, with sharp incentives - but we also know that not all customers are the same, with different regional priorities. It is unlikely that any market (which regulation should seek to mimic) would produce such a limited set of service parameters.

It is reasonable for Ofwat to propose rationalising the number of PCs, and we believe that companies will respond to this suggested direction of travel without the need to prescribe 'around three' bespoke PCs. Ofwat could consider a smaller change to tackle this issue rather than such a prescriptive approach that forces companies to have no more than a specific number of bespoke PCs. This might involve setting stronger principles for bespoke PCs. For example, these might need to be outcome focused; demonstrably more stretching than common PCs; and strongly supported by customers (or part of a long-term commitment to customers).

Although Ofwat is removing non-financial PCs, we will continue to set ourselves targets on those which continue into AMP 8 – and report against them. This is particularly important for those non-financial PCs where we have made long-term commitments to customers.

Q5.3. Do you agree with our proposed approach to setting standard rates?

We do not agree with the proposed approach to setting standard rates. We understand why Ofwat plans to set standard rates for ODIs, with financial underperformance and outperformance payments. In our responses to previous consultations, we have supported some **peer review of Ofwat's proposed approach** which highlighted some challenges with the proposed methodology - but we do not intend to repeat these here. We consider that, in line with previous Ofwat policy on service valuation, we should be seeking to triangulate evidence from a range of sources. We intend to carry out our own service valuation evidence to complement the work Ofwat is doing, alongside other datasets such as complaints. We hope this additional evidence will be helpful in reaching a sensible and balanced set of proposals for service incentive rates.[5]

We do not agree with Ofwat that the risk associated with extreme weather events should sit entirely with companies. This would not be consistent with the long-standing principle that risk should sit with the party best able to manage the risk. Exclusions for weather events remain appropriate because they are an unavoidable asymmetric risk to companies which we cannot manage – that is, companies cannot control the weather; and extreme weather events will always have a negative impact on costs and performance. For example, while we can invest to make sure we increase our resilience to extreme weather impacts (for example, by increasing the scope for onsite power generation at our sites), we could not reasonably invest to mitigate an extreme weather event which suddenly led to a widespread power outage across all of our network. This highlights that this risk is something that can be mitigated to some extent, but not completely avoided. Removing these exclusions would mean that consistent good performance would be countered by extreme weather events, creating considerable downside risk. That downside risk would either drive uneconomic investment by companies to mitigate these extreme events or increase the cost of capital for customers - or both. It is for this reason other

[5] We note that this evidence is needed to create a "best value" business plan in any case, and so can support both purposes.

regulators have consistently decided that the risk is best shared between companies and customers. For example, the interruptions incentive for electricity distribution networks (p48) excludes exceptional events for this reason:

> "11.8. The IIS does not include certain items which we deem outside the DNO's control, or not suitable for the scheme. These are exceptional events, cut-out failures and short interruptions."

Ofwat should set out clear triggers for when a weather event could be considered 'extreme' – for example, the Met Office would provide a clear and independent trigger using 'red' weather warnings. Where this trigger occurred, companies could then make a case to Ofwat for an exclusion which would need to show the root cause of the service failure and evidence the extent to which the company could have acted differently to mitigate the impact on customers. This would still place a burden on companies to evidence any exclusions and allow Ofwat to consider the evidence in the round.

In circumstances where it is appropriate that underperformance payments should be made, customers might not always prefer underperformance payments to be returned to them in bills – but instead might value improvements in future service more highly. This is particularly the case for extreme weather events, where a better outcome might be to allow companies to reinvest underperformance payments where these relate to events outside the company's control – rather than insisting this is returned to customers. There is also a question about whether the penalty is paid back to the generality of customers or those most affected, which will generally be a very small subset of a company's customer base. We would support changes that gave companies more flexibility in consultation with their customers and under the guidance of their customer challenge groups, Ofwat and CCWater to agree remedies that address any customer harm in a more targeted way.

We, alongside Yorkshire Water and South East Water, have commissioned some work to examine the impact of removing exclusions for extreme weather events, and some alternative approaches. We will share this work with Ofwat when it is complete in mid-September, through the Future Ideas Lab.

Q5.4. Do you agree with our proposed approach to the measures of experience performance commitments, including to increase the size of C-MeX?

We agree with the proposed approach for C-MeX, but not for BR-MeX. Customer experience has always been important to us and we put customers at the heart of everything we do. We have been working hard to make sure we're now among the top performers in the sector. Our ambition is to go further than this on customer experience, as we should be comparing ourselves to other sectors too – and not just other utilities, where the best water companies are now among the top performers.

C-MeX should be a larger, symmetric incentive. Our customers value a good experience, and the combination of C-MeX incentives and efficient retail costs has allowed us to go further on areas like affordability and community engagement. This has added real value for customers and supported a virtuous spiral of improvement that should continue. C-MeX has met its design criteria, as set out in Section 3.1 of Appendix 6 of the consultation.

Customer experience is becoming more important and across all sectors is being understood more as a competitive advantage. Customers have higher expectations about customer service and are willing to switch to companies with good customer service rather than just on price (for example, successful retailers have led on customer service in the energy sector, rather than price). As C-MeX is designed to reflect customer and market changes, it is now right to look again at customer valuations of a good customer experience.

C-MeX already has large penalties, which could potentially divert funds away from improving retail services, and these apply only to a small number of companies in a meaningful way. It is not much of an incentive for the lowest ranked companies if a big improvement leads to the same penalty. It would be sensible to work with those companies to understand how they are driving improvement in their retail services.

Companies close to or at average have a much-reduced incentive to improve further – based on the 2020/21 results, for example, there isn't a big incentive for moving from 81 to 83. Increasing the incentive for outperformance could help to encourage companies who are already above (or close to) average to improve their customer service further. This could be an opportunity to make C-MeX symmetrical, in line with other ODIs and customer valuations. Customer valuation of customer experience would likely support such an increase, and we encourage Ofwat to consider this in its research.

The criteria for higher performance payments have, in practice, proved to be too difficult for companies to achieve. This is because of limitations in the UK Customer Service Index (UKCSI) survey gateway – this uses a panel methodology, which was not designed for this purpose, and makes it almost impossible for utilities to achieve upper quartile performance. We, and other water companies, have raised concerns about this methodology and the unreasonably high bar for higher performance payments (for example, in our response to the PR19 draft determinations).

Ofwat noted in **its PR19 final determinations** that its analysis showed that an improvement of 2% to 3% in C-MeX would allow companies to meet the gateway for UKCSI – but in practice, while Dŵr Cymru improved from 82.47 in 2019/20 to 85.15 in 2020/21, it did not meet this gateway. This shows that this analysis was incorrect and suggests that the gateway for higher performance payments is indeed too high. This analysis was not revisited or tested in the methodology consultation.

Ofwat should set symmetric C-MeX incentives, with the outperformance payment set at the same rate as underperformance payments. This would mean removing the gateways for higher performance payments, which have proved to be unachievable and so ineffective as an incentive.

We are concerned about the removal of check and challenge, and we do not recognise Ofwat's characterisation of challenges being focused on technicalities rather than accuracy. We have successfully challenged and have demonstrated that on occasion, the survey delivery partner has missed inconsistent responses from customers or has been led or prompted to inaccurate scores. Simply "continuing to work with survey agents" does not address this, and this has not been effective so far at ensuring quality and consistency.

Check and challenge should be extended to online responses too. This is because the online surveys cannot be as clear about focusing on a specific incident, and so sometimes customers respond about other topics or contacts, which can mean this is allocated to other survey types. These can also be contradictory, too – for example, every response is excellent, but the score is a 1 rather than a 10. This is inconsistent with telephone surveys, where agents can refocus on the topic of research or query answers that look like errors. As we become more and more digital, these issues will happen more frequently.

BR-Mex proposals

We do not agree with Ofwat's proposals on BR-MeX. We recognise that as a monopoly wholesaler there is a strong case for introducing an incentive with rewards and penalties to drive improvements in wholesale service. This is currently carried out by the Market Performance Framework (MPF) outside of the price review supported by the retail market operator. We believe that this framework is not working well and driving the right focus from wholesalers and so support the reform of those arrangements. The new incentive framework could either sit in the price review or in the MPF - the latter ought to be more flexible to change over time, but the former may be necessary in the near term to attract strong focus from wholesalers.

A business customer measure of experience as a common PC is difficult to implement, as the relationship between retailers and customers is not completely within our control. This is not really resolved by seeking feedback directly from end business customers, who would receive much of their information from retailers who own those relationships. We are also concerned that this measure is not yet designed and would not be available until 2024 – that isn't the same as C-MeX or D-MeX, where parts of these measures were widely tested and understood for years beforehand.

For R-MeX, while we believe the survey data is useful, the dataset is small (only 13 retailers participated) and not necessarily independent of the wholesalers (many retailers are part of group companies alongside wholesalers). Also, not all retailers participate in all wholesaler areas. Our concern over the reliability of the survey to use as a basis for adjusting

customer bills is reflected in the decision by Market Operator Services Limited (MOSL), the market operator for the non-household retail market in England, to retain the survey results as reputational and not to apply rewards or penalties - the **MOSL Report** stated:

"It is proposed that the R-MeX will not result in the application of any performance standard charges. This reflects feedback from Trading Parties to the RFI and concerns that the response rates may not be statistically significant to use as a basis for performance charges."

However, we do see the benefit of incentivising good customer service in the market – and support the development of measures to do this, as well as the objective of improving the experience of business customers.

The MPF currently duplicates this incentive – in that this intends to drive wholesale performance. The MPF shows that this incentive is working to drive performance over time (compliance has risen by 40% over five years). We also note that fines under the MPF are much smaller than the proposed BR-MeX incentive (around 0.05% of wholesaler revenues relating to the business market). This incentive should increase to make sure this is higher than the cost of non-compliance, but not to a level many times higher, which is very unlikely to reflect customer willingness to pay.

We are pleased to see that Ofwat is actively engaged in work to reform the MPF and note that MOSL's view should be taken into account – this incentive should not be included in both the MPF and price controls without considering them both together.

There are some measures that can be taken to support the introduction of this incentive:

- We welcome the proposal of collaborative working to develop the measure, including pilot surveys. However, it is not sensible to assume that the pilot survey will be successful (or to rely on a single pilot) and so the timetable outlined is unlikely to be met in practice.

- Given the existing concerns about R-MeX sample sizes, and that we don't know how stable this new metric will be, Ofwat should consider not applying the financial incentive in the first two years of the control. This islike the introduction of both SIM and C-MeX, which tested the metrics for two years before using them as incentives. Ofwat could consider building in a "gateway" that allows it to remove BR-MeX incentives mid-period if the early results are not considered robust. This doesn't reduce the incentive for companies to improve but would reduce the risk of poorly targeted incentives and providing outperformance/underperformance payments that don't reflect actual performance.

- The proposed outperformance/underperformance rates are extremely high and should be substantially reduced. Ofwat calculated these as a proportion of NHH wholesale revenues, specifying that this should be the same relative magnitude as C-MeX. However, this is a very different operation to household retail in practice – all companies have much smaller teams dedicated to dealing with retailers and business customers than they do for household customers. Not because those customers are less important: but because they have less frequent contacts with retailers and business customers (business retail competition means that retailers do most of the equivalent work, by design), and the customer facing activities are much smaller as a proportion of non-household revenue. We suggest that for example, this could be done as a similar proportion as C-MeX but scaled for the relative costs of serving customers across each service.

- Using Welsh Water data (the only large company with both HH and NHH retail functions), the BR-Mex range should be set at **+0.3% to -0.6% of NHH revenue**, to match the +6% to -12% retail revenue range of C-Mex.

- Alternatively, Ofwat could undertake some stated or revealed preference research with NHH customers directly to understand the value those customers place on wholesale service performance and reflect that in the incentive (perhaps with the support of MOSL and market participants).

Figure 4 – Setting the BR-Mex range for a 6% to -12% Retail revenue range

Welsh NHH Retail	2021/22	2020/21
NHH Total revenue £m	151	133
NHH Retail revenue £m	7.3	6.3
NHH Retail Rev/Total NHH Revenue	4.9%	4.7%
Max Reward % of retail revenue	6%	6%
Max Penalty % of retail revenue	-12%	-12%
Reward £m 6% * NHH Retail revenue	0.441	0.375
Penalty £m -12% * NHH Retail Revenue	-0.881	-0.751
BR Mex as % of total revenue		
Reward / NHH Revenue	**0.3%**	**0.3%**
Penalty / NHH Revenue	**-0.6%**	**-0.6%**

Data source – 2021 & 2022 APRs

Q5.5 Do you agree with our proposed approach to estimating marginal benefits for common and bespoke performance commitments?

We do not agree with the proposed approach. Companies should own their relationship with their customers and should carry out this research – but we recognise the challenges around variations of rates at PR19, and so we have supported the centralised approach. We supported some peer review of the research methodology by Eftec, alongside other companies, and Ofwat has published this on their website.

As part of our work to assess best value, we have carried out work to estimate customer valuations of the common PCs, along with some of our bespoke PCs from PR19. Ofwat should consider all the evidence in estimating marginal benefits for PCs.

Q5.6. Do you agree with our proposed approach to incentivising Asset Health performance?

We do not agree with the proposed approach. We are pleased to see the greater focus Ofwat is putting on asset health through its operational resilience work and are keen to support the development of that work. We agree that Asset Health measures in PR24 should be supplemented with further monitoring outside the price review.

Asset health monitoring could be improved greatly from the historical approach, and we welcome the steps Ofwat, and the sector, are taking to start doing this. However, it wouldn't be sensible to set further incentives before we have had more in-depth discussions around Asset Health and how we should set the appropriate level of investment and monitor performance on this.

We do not think it is sensible to set Asset Health PCs using short-term incentives like other ODIs while Ofwat acknowledges that these PCs only represent a partial view of operational resilience and where fundamentally these are long-term issues. This would incentivise a focus on improving specific measures in the short term, rather than incentivising appropriate long-term stewardship of assets across the sector.

For PR24 we may decide as a sector that there is insufficient time to develop a broader and better suite of leading and lagging Asset Health indicators in which case it may be a pragmatic stepping stone to retain some Asset Health ODIs. However, the long-term objective should be to implement a broader framework that assesses Asset Health comprehensively and completely, and for that framework to be linked more directly to the assessment of efficient costs (rather than using a short-term ODI regime).

Q5.7. Do you agree with our proposal to retain, expand, and streamline enhanced incentives?

We do not agree with the proposal. We recognise Ofwat's analysis on the proposal to retain, expand and streamline enhanced incentives – and we provided our views in our response to the February 2022 discussion document. We said that these could encourage companies to spend more on improvements than the benefits created for customers – which would not be in the interests of customers. We also noted that the service improvements from enhanced ODIs should not be applied to other companies in the sector, who will not have had access to the same funding provided by the enhanced ODI rate and so cannot deliver the same improvements. We support the principle of enhanced incentives if these challenges can be overcome.

Q5.8. Do you agree with our proposed approach to selecting performance commitments for enhanced incentives?

We agree with the proposed approach to selecting PCs for enhanced incentives. We also agree that there should be careful calibration of incentives for water demand, as it is not clear that there are benefits for customers in reducing demand beyond an efficient level for its own sake (compared to, for example, where zero pollution incidents or zero sewer flooding would be a desirable outcome).

Q5.9. Do you agree with our proposed approach to setting enhanced thresholds, rates, and caps?

We do not agree with the proposed approach. An alternative to capping these incentives financially is to do so based on performance levels – Ofwat notes that this is already the case on pollution incidents where frontier performance is already close to zero. Companies will set out their long-term ambitions for each PC in their long-term delivery strategy. Ofwat could consider capping enhanced performance at this long-term ambition level – as this represents customer views about where they expect water companies to get to, and they do not expect to pay to go beyond this performance level.

Q5.10. Do you agree with our proposed approach to knowledge sharing?

We agree that this knowledge should be shared with the sector, though Ofwat says that it will claw this back "if we consider a company's knowledge sharing activities are inadequate". The final methodology should include more detail on this to provide more certainty to companies who plan to achieve enhanced performance. Companies would use the enhanced ODI to fund the costs of outperformance, and the innovation required means this is already risky – an additional risk that these costs might be spent and then the revenue clawed back would provide a barrier to investment. Ofwat

should provide more certainty around how any judgement of what constitutes reasonable knowledge sharing should be carried out.

Q5.11. Do you agree with our proposal to set caps and collars on a targeted basis, and apply a two-sided aggregate sharing mechanism to all companies?

We do not agree with the proposal. When setting any ODI, Ofwat should consider the unintended consequences – for example, where performance is not entirely in the company's control, or where there are changes in monitoring or definitions. Caps and collars play an important role in dealing with these situations, and Ofwat should consider applying these where these are relevant rather than removing them by default. This would particularly be an issue if extreme weather exclusions were removed – these can create significant penalties due to factors that are mostly outside the control of water companies (for example, Storm Arwen).

However, capping some PCs could lead to unexpected outcomes – for example, we have worked hard to be a leading company on Net Zero, with strong outperformance against our PC in 2020-25. For us, this is a well-established PC, and we expect to meet our first milestone on Net Zero by 2027, but this relies on investment funded through outperformance against this PC. A cap could restrict this investment and so delay our progress.

Ofwat could mitigate this risk by assessing the levels of these caps and indicating where they might apply in practice (this can only be done with indicative information about the size of ODIs). Caps and collars are most beneficial in situations where there are very short-term factors that are mostly outside of a company's control, but where a single event has a very large impact on performance (such as extreme weather and supply interruptions). There may be less need for caps and collars in areas where the metric more closely reflects performance and company activities.

Q5.12. Do you agree with our proposal to not set deadbands on any performance commitment?

We do not agree with the proposal, nor do we agree with the proposal to remove exclusions from PC definitions. There are good reasons for deadbands in some cases, for example, where the PCL is set at full compliance (such as CRI or discharge compliance) and so any gap even if it is small will trigger a penalty, where there are measurement issues that may create a degree of error in the reported figures, or where performance can be influenced by factors outside of company control. In these instances, deadbands are entirely appropriate.

Ofwat set a deadband for CRI (a score of two) to make sure outcomes remained achievable and equitable when used as a water quality objective; and in 2020/21 the whole sector would receive a penalty if there were no deadband. Similarly, the Environment Agency (EA) sets a target of 99% for discharge permit compliance. We might expect customers to value

a company moving from (for example) 97% to 99% (or "red" to "green" in the EA's Environmental Performance Assessment (EPA) more highly than a company moving from 99% to 100% (both "green"). Removing the deadband is likely to weaken the strengthen of the incentive considerably. Eliminating all risk of incidents is prohibitively expensive and should not be penalised – and using deadbands means that penalties are applied only for poor performance.

Setting full compliance PCLs without deadbands will lead to penalties for most companies, and so would be an asymmetric incentive. Asymmetric incentives with a below-zero expected return would need to be compensated for elsewhere so that the package as a whole remains a "fair bet".

We suggest an alternative approach, with a deadband set at current levels for these PCs, and instead a reward for achieving the full 100% or zero target. This approach would incentivise companies to drive towards achieving the full compliance target, without rewarding companies for a non-compliant performance, while preserving the symmetry of ODIs. At a minimum we consider that deadbands should remain for the compliance based-ODIs or targets set to reflect the issues highlighted.

Exclusions for unplanned outage

The new Ofwat definition for unplanned outage removes some exclusions, particularly for raw water quality issues. We can understand why Ofwat would seek to remove exclusions for simplicity, but this would have a significant impact on the performance level that can be achieved – simply because for some treatment works, raw water quality makes a difference because of the processes used. Choosing to operate at a lower peak week production capacity (PWPC) to maintain water quality should not be considered an asset failure.

This is particularly relevant for our slow sand treatment works in Essex and Suffolk, where water treatment involves slow filtering through a layer of film – this must be skimmed and replaced periodically, and filters are carefully monitored for how effective these are at bacterial reduction. A sand filter must be taken offline (in an "unplanned" way) if there are any issues – this is part of normal operation at these works. These treatment works are not designed to operate under some raw water quality conditions.

At PR19, Ofwat challenged our plan to install pre-treatment at the Layer Water Treatment Works (WTW) to address the issue of raw water deterioration. It eventually accepted the need for enhancement expenditure to make sure the deployable output of Layer WTW is maintained during times of algal bloom in Abberton Reservoir (this investment will now reduce the risk at this treatment works). The risk of outages for turbidity and algae continues to be a risk at our other slow sand treatment works (Langham and Chigwell). Algal issues have become more prevalent across our areas, and this causes problems with both the clarification and filtration processes, as well as sludge management and dewatering in the North East.

Removing these exclusions adds to our risk under this PC, where we would be unable to tackle this issue without significant enhancement expenditure. Exclusions for raw water quality were previously included in this PC for 2020-25 because Ofwat recognised that this was not related to Asset Health (which is what this PC is seeking to measure). Removing exclusions will lead to a worse score on the metric, without reflecting any worse performance – due to the nature of the treatment works we have.

Ofwat should continue to exclude raw water quality issues from this PC. We suggest Ofwat requests information from water companies to understand the impact of removing these exclusions, to support making this decision and/or to support setting a new PCL that reflects the difference between types of treatment works and the impact of removing exclusions for raw water quality. Ofwat should also consider the link between enhancement expenditure on addressing raw water quality, and this PC.

We note that removing deadbands is relevant to this issue too, as these allow companies some flexibility to choose to reduce PWPC to avoid impacts on water quality, without immediately incurring a penalty. Removing exclusions for raw water quality makes this measure less effective as a proxy for Asset Health but removing deadbands means that this incentive would also penalise the right operational decisions.

Q5.13. Do you agree with our proposed approach to estimating ODI risk?

We do not think that Ofwat is able to make judgements on ODI risks and should instead use evidence from water companies.

Q5.14. Are there instances where providing greater clarity over our intended approach to incentive rates in PR29 would clearly be in the interests of customers? Please explain why and provide supporting evidence.

Companies will set out their long-term ambition for PCs in their long-term delivery strategy. For some of these, there are already long-term government targets. At PR19, we set ambitious goals based on longer-term customer ambition and anticipated long-term government targets.

If Ofwat wants to incentivise a long-term approach, it could set some expectations on its approach to outcomes for future price reviews. This has already been done in some instances, such as the long-term targets for leakage, PCC, pollution incidents, and Net Zero. Ofwat could also comment on the long-term ambition for each company, and whether they think these meet customer and government expectations. This might support companies in understanding and then outperforming the trajectory towards the long-term ambition, rather than the sector's focus being on short-term

comparisons with other companies. Ofwat could set a reasonable expectation that companies can expect PCLs to be set around the long-term ambitions, with an efficiency challenge based around how well the sector is able to outperform these. We might expect that the sector could achieve these long-term ambitions earlier than planned.

We also encourage Ofwat to set long-term incentive rates across multiple price control periods. As Ofwat has itself highlighted, customer preferences in the water sector have a degree of consistency over time. It should be possible to set consistent incentive rates over multiple periods where these rates demonstrate the appropriate incentive strength to drive change, reflect customer's willingness to pay and exceed the marginal costs of improvement.

The more predictable future PCLs are along with the associated incentive rates, the easier it will be for companies to take long term decisions that involve significant investment now with a payback over several AMP periods. Without this certainty and the threat of PCLs ratcheting up to claw back any performance improvements during a period then companies will not be able to extend the horizon over which they make certain investments which will not be in the customer interest.

Doing this would encourage companies and their investors to take a longer-term view on investments with a pay-back period of more than five years that support service improvement. We note, for example, that the incentive strength around SIM, and now C-MeX, has remained consistent and clear across multiple control periods encouraging long-term investment to improve customer experience performance with substantial benefits.

Q5.15. Do you have any comments on our proposed approach to implementing and streamlining payments at PR24?

We support in-period application of the ODIs, though the proposed biodiversity PC does not seem to work as an annual PC. We suggest that Ofwat retains the flexibility to defer in-period payments to manage bill stability if companies propose such a deferral, including deferring payment to PR29 if necessary. These could still be implemented through revenue, not RCV.

QA6.4 Do you consider evidence suggests that the current water supply interruptions performance commitment is inhibiting innovation? If so please provide it.

There is some evidence that this might be the case. We have been working with a third party to develop a "no dig" leak repair technology, based on injecting a material into pipes to seal leaks. This was demonstrated recently at our Innovation Festival, where after trials on abandoned mains, this approach was used to successfully repair an 8" main. This was in a town centre, and this would have usually meant substantial road reinstatement and disruption for around a week. However, this method took one hour to repair the leak, with no road works required.

We are now monitoring how long the repair lasts, but this (or other technology) could significantly enhance the way we find and repair leaks in future. Technology like this can require a supply interruption to allow the materials to cure, so the supply interruptions target could be a barrier to innovation.

This could be tackled in the definition by excluding supply interruptions that relate to trialling innovative technology where this is clearly in the interests of customers. In our example, local customers received improved service overall by avoiding significant disruption. Ofwat could consider limited regulatory sandboxes for other PCs too, to allow for innovation – and prevent short-term targets from becoming a barrier to long-term improvements in service.

QA6.5 Do you agree with our proposed definition for the biodiversity performance commitment?

We do not agree with the proposed definition. We agree with Ofwat that we can play a critical role in maintaining and enhancing biodiversity, and this should be measured consistently. We always work hard to improve biodiversity across our land, with dedicated conservation and land managers, and we are disappointed that the methodology consultation doesn't reflect the excellent work that many companies have already carried out. Although it is worth developing this metric further, we suggest it should not be used as a financial incentive at PR24.

This PC is difficult to define and measure, with many complexities to be considered, and we welcomed the opportunity to discuss this in the working group. The definition in the methodology sounds simple, but would be ineffective in practice.

There are multiple sources of funding for biodiversity improvements – from WINEP, to grants for habitats, peatland restoration, tree planting, and others. Credits for biodiversity can also be sold to others. An additional financial incentive through an ODI could be a barrier to improving diversity, rather than an incentive, if these other methods were excluded from the definition. Either the ODI would be set at a rate that is not competitive with these other methods, so would not see any improvement - or if it were set at a higher rate, it would disincentive companies from using other methods.

It would be unreasonable to exclude improvements from work done by third parties (for example, securing funding from elsewhere through habitat creation grants) from the biodiversity PC as it would create a perverse incentive to not seek out external funding but instead rely on customers. However, if these are included, local communities effectively pay twice for improvements (through the grant funding, and then again through water bills via an ODI).

This issue means that a financial incentive is not necessary and would create unintended consequences, therefore not achieving the aim of improving biodiversity in the round.

Some companies have been better performers than others in improving biodiversity. A baseline measure like this would not take current performance into account (effectively, it would assume that a baseline reflects equally good historical performance for all water companies – which is not the case). This PC would disproportionately reward those companies who have not been proactive historically.

The baseline assessment would be across all sites – but many of these sites are small, and so a visit from a qualified person would be a disproportionate cost for the benefits that can be accrued. For example, we have around 1,900 sites – and 0.6% of the total area (of 8,400 hectares) is made up of 1,340 sites that are less than 0.5ha in size. Many of these smaller sites are for assets such as kiosks, pumping stations and water towers – comprised nearly completely of areas of hardstanding, some with small areas of amenity grassland. When we carried out our natural capital account, we concluded that as the area of these smaller sites is less than 2% of the total landholding, the effort required to identify the associated habitats on those sites would be excessive to the impact that the information would have on the natural capital register and on the account. We estimate that assessments on sites below 0.5ha would be around 55% of the costs of the total for baseline assessments (compared to just 0.6% of the land). There should be a lower limit on the size of land that can be assessed.

Removing sites that are smaller than 0.5 hectares would remove most of the measurement costs but would still measure 99.4% of the total benefits. That doesn't mean we would ignore these sites when improving biodiversity (as there are still benefits in doing so where possible), but that the costs of calculating and applying the incentive outweigh any benefits to customers from setting such an incentive.

There are many constraints on further enhancement to water company land – and these vary between water companies. For example: around half of our landholding is open water, where there is very little opportunity to create change that would be identified in Biodiversity Metric 3.1; there are historical rights on agricultural land and shooting rights which limit our ability to influence future land use; and there are operational restrictions driven by water quality constraints and future growth planning.

The definition for biodiversity asks for an independent qualified person to make a site visit. This definition excludes the ability for in-house staff to take on some of the survey effort and so reduce the cost of the work, particularly for smaller or simpler sites. It also removes the opportunity for us to take advantage of advances in technology, with other sectors promoting the use of satellite imagery and artificial intelligence (AI) to enable condition assessments in the future. We have explored such technology at our Innovation Festival and projects of this nature are in our innovation pipeline. This PC would "lock in" site visits for years to come.

Repeating the assessment after four years is not justified from an ecological perspective. Our survey strategy means that we aim to survey sites which we manage for their conservation value every five to eight years. For sites >0.5ha, we used

to identify the potential for protected species and the presence of invasive species every three to six years but have recently concluded that every six years is sufficient because there is very little change on site. Where we make changes in how we manage sites, we survey more frequently in the short-term, reverting to longer intervals once the land has become accustomed to the change in management. For woodland sites, it would be normal to survey regularly if they are newly established woodlands, but once established the site is resurveyed every ten years. There would be very few, if any, changes that could be captured within a four-year period.

The Environment Act requires us to report on the biodiversity value of our landholding every five years – which is out of sync with the four yearly survey period proposed. Additional measurement requirements, set only for the application of a price control incentive, are not cost beneficial for customers. Instead, the survey period should be in line with what is appropriate for different habitat types and aligned with the Environment Act requirements, and the reporting should be every five years, taking into account the most recent surveys where longer periods are more appropriate.

We have concerns about setting a target for delivery of biodiversity net gain against the estimates included in WINEP schemes. WINEP acknowledges that the biodiversity net gain assessments for these are purely indicative at this stage and can't be further refined until specific sites have been purchased, ground conditions assessed, archaeological implications understand, and the other assessments completed that are required prior to any project being fully designed and being at a stage that is suitable for a planning application. This introduces a great deal of uncertainty in setting robust PCs at PR24.

We also have some concerns about how this PC definition will change over the next thirty years – baselines will have to be updated to reflect changes to the metric (which Natural England advise they expect to happen every four to five years). This will make it difficult to assess comparative performance over time.

We understand that Ofwat is seeking to measure the outcome of the work carried out by water companies on biodiversity enhancements – and so using a common PC and ODI would achieve this. However, the practicalities of doing so mean that this incentive will not be well targeted at the right activities and companies; the cost of measurement is higher under the incentive for no real advantage to customers; and this could lock us into legacy definitions and methods in future. There is a real risk that customers could lose out from this across the sector. If Ofwat thinks that a financial incentive is the right approach, we suggest that the committed performance level is set at the current level for all companies, so providing an additional funding route for biodiversity improvements without distorting the incentives to obtain grant funding from elsewhere.

Instead, we suggest that Ofwat focuses on:

- Making sure WINEP funding for biodiversity enhancements is fully spent by water companies (we recommend through a PCD on activity), with each water company reporting on its progress.
- Within this, setting expectations for water companies to develop suitable reporting systems and geographic information systems (GIS) to measure and publish records that align with the proposed exclusions from this PC (and ideally, publish all biodiversity information as open data). Ofwat should signal that companies should include this within their WINEP programmes and allow funding to do so.
- Measuring biodiversity improvements to understand how companies achieve and fund this, to enable a full impact assessment before introducing incentives. This would avoid setting a financial incentive that creates barriers to improving biodiversity.

Given these challenges, this should be a commitment to measure in 2025-30, with a financial incentive being introduced from 2030 if this proves to be a viable methodology and we have evidence that a financial incentive is needed (and does not create new issues).

QA6.6 Do you agree with our proposal to have separate operational greenhouse gas emissions performance commitments for water and wastewater, which are based on a normalised measure?

We agree with most parts of the proposal, but suggest some improvements. We published a short report suggesting an approach to incentivising Net Zero across the water sector in the **Future Ideas Lab**. There is a high degree of consistency with our proposed approach and Ofwat's consultation proposals, which we therefore support.

Percentage reductions from a base year would disadvantage companies who have made the most progress already, and we would strongly disagree with this. As we reported, some companies still have scope to make sufficient emissions reductions at low additional cost, as the marginal cost of abatement is still low for them. We have already taken many of these opportunities, and we are outperforming the sector.

We agree that a normalised measure that would reflect progress made to date by different companies is most appropriate, with careful consideration of the normalising variable (such as volume, as an estimator of relative emissions). We understand why Ofwat proposes two PCs (for water and wastewater) but note that this should also require some allocation of retail emissions too and we currently have a single PC for the whole business, which works effectively. This is economically more efficient because we are incentivised to find improvements in the most effective place, rather than considering separate incentives, and is simpler and easier to report. This would also remove any substitution effects from

incentives – if, for example, a company had focused on reducing emissions in wastewater rather than water, this would not penalise them when compared to water-only companies.

There may be an opportunity to streamline the proposals into a single PC at the appointee level (and comparative performance can be set and assessed by reporting water, wastewater, and retail separately).

The GHG emissions reduction hierarchy is a well-established approach. However, Ofwat should recognise that offsets and insets have an important part to play in delivering efficient emissions reductions. The use of effective and robust offsets and insets enables the most efficient solutions to be adopted, allowing us to move towards Net Zero at the lowest cost to water customers. This is because companies will only choose to use these mechanisms where they are cheaper than other interventions to reduce emissions. Inset projects can often mean local community-based action, including planting trees, bringing wider benefits to our regions.

Finally, we agree with Ofwat that there is a need to invest time and energy to make sure emissions reporting can be carried out robustly and consistently across the sector, particularly for scope 3 emissions. We recommend focusing on this during 2025-30.

QA6.8 Do you agree we should focus the bathing water performance commitment on the outcome that customers have received and should continue to develop an alternative definition to do this?

We do not agree with the bathing water PC in full. The bathing water quality PC needs to recognise that there is a shared responsibility for bathing waters, rather than assuming that any acknowledgement of this shared responsibility is an attempt to shift responsibility. Tackling bathing waters is complex and setting an ODI that assumes companies have full responsibility (and therefore allows no exclusions) does not incentivise companies to act but instead removes some of the funding that would otherwise be available to tackle this sort of complex issue.

For example, we currently have a bespoke PC for bathing water compliance. Two bathing waters did not meet the "Good" or "Excellent" category – Marsden, and Cullercoats.

Our WINEP investigation at Cullercoats started in 2020 and builds on extensive partnership investigations with the EA and local authority (LA) since 2017. A detailed review was carried out of all previous studies including the National Environment Programme (NEP) investigation in 2011 that identified an uncharted polluted drainage culvert belonging to the LA that was capped off from the beach. Further targeted investigations and surveys were then carried out and indications are that contaminated groundwater is the most likely primary reason for the deterioration in bathing water quality. There is no evidence that our assets have an impact. We have had positive engagement with the Cullercoats

Collective, a local interest group with wider-ranging membership including members of Surfers Against Sewage, but with a broad town-wide remit. We remain committed to working with our partners including North Tyneside Council and the EA to improve the seawater quality at Cullercoats for our customers, local businesses, and recreational users. We publish information and updates to the local community.

This demonstrates the challenges that companies face in achieving a "good" or "excellent" rating. For Cullercoats, the responsibility is not with our assets, and there is no easy work that can be done to tackle this. It is not reasonable to describe this investigation as "focusing efforts on attempting to establish fault' (as the methodology consultation describes), as this has been clearly focused on working with partners and the local community to solve the problem. We have committed to achieving 100% of coastal bathing waters at Good or Excellent standard by 2030.

We are now working with the local council to divert the culvert flow into our sewerage network and are seeking to develop models of potential pathways for groundwater contamination. These are complicated issues, which often require significant investment and partnership working to resolve. A penalty through an ODI does not allow efficient companies to finance carrying out their functions in this area.

In these situations, the ODI doesn't incentivise companies to act but instead removes some of the funding that would otherwise be available to tackle this sort of complex issue. There are two options for addressing this:

- Ofwat could set the PCL such that tackling the most difficult cases is not included – these could be where a) poor bathing water quality is not the fault of the water company; and b) where the costs of tackling the issue exceed the ODI. These difficult cases would instead mean an outperformance payment when these bathing waters are improved, reflecting the willingness of customers to pay for improvements to the environment, even when water companies are not directly responsible.
- Ofwat could exclude the most difficult cases from the PC entirely (through a deadband or exclusion), and deal with these cases by funding through WINEP with a PCD to track this expenditure.

QA6.9 Do you agree with our proposal for the river water quality performance commitment to measure the reduction of phosphorus entering rivers?

We agree that this sort of commitment is needed, but this does not go far enough. This PC could work, though we note the overlaps with other PCs and the need to be joined up with WINEP (where there is likely to be significant investment needed in phosphorus removal at sewage works in 2025-30). By its nature, this PC will be delivered primarily through enhancement expenditure either to meet tightened standards on P-removal at sewage treatment works, or through wider partnership working such as the Catchment Based Approach and Catchment Partnership activity and the **Northumbria Integrated Drainage Partnership**.

The PCL should be considered alongside enhancement expenditure – if enhancement expenditure is disallowed in the price review (for example, due to unclear need or customer support) then this should be reflected in the PCL too.

Ofwat should be more ambitious on the river water quality PC, going beyond measuring phosphorus. Reflecting this in the ODI might not be possible in time for PR24, but Ofwat should consider setting a wider challenge to water companies to propose further monitoring of river water quality (not just at treatment works), to improve more water environments, and to explain how they are working with partners to improve this. Ofwat should signal how they will consider proposals for enhancement funding for this.

We currently have a bespoke ODI for improving the water environment beyond our statutory obligations, with a new environmental measure for improvements to km accessible water environments (bluespaces) established in 2020-25. This ODI is overseen by a **governance group of external stakeholders who** provide evidence of external assurance to Ofwat. We are outperforming our PC of 10km per year (64.8km improved by March 2022, compared to a target of 20km), with this ODI providing the funding to meet the costs of making improvements beyond the target – for example, in 2021/22, we invested £171k and received an out-performance payment of £189k.

This bespoke ODI has allowed for the completion of 14 partnership projects so far, with a further 22 projects launched into delivery. We have launched a new funding scheme called bluespaces to provide the platform for developing and delivering partnership projects to support this work. In 2022/23, we plan to achieve more than 66km of water environment improvements.

We would be disappointed to see this success in delivering customer-focused environmental improvements end in 2025, which is a risk if PR24 mechanisms do not allow non-statutory programmes such as this to be funded. We consider there are two options for continuing to deliver in this area for PR24: as a continued bespoke ODI, or within a non-statutory WINEP driver. We will continue to engage with Ofwat and others, including the EA, on how (1) we can make sure customer-focused, above-and-beyond environmental schemes like this with wide benefits can justify inclusion in WINEP during Ofwat's PR24 assessment of enhancement expenditure; and (2) how we can make sure the efficient level of funding is available for ambitious partnership schemes such as this to be delivered for our customers.

7. SETTING EXPENDITURE ALLOWANCES

Q6.1. Do you agree with our proposed approach to setting efficient expenditure allowances at PR24?

We do not agree with Ofwat's proposed approach. We support Ofwat's intention to build on the PR19 benchmarking models. The fundamental engineering and economics of operating a water and wastewater system have not changed, and there is no need for significant change unless there is a compelling case.

Ofwat notes that it is collecting additional cost data and intends to publish an updated base cost modelling dataset in Autumn 2022. We would like Ofwat to update the data from third parties too – that is, density and the measures used in the bad debt models for retail. This would allow a complete updated picture of cost models.

Historical costs are not always a good indicator of future costs. This is particularly the case for operational resilience and Asset Health, where replacement rates for assets have been set at unsustainably low levels at successive price reviews. Ofwat's 2017 targeted review of Asset Health noted that this has led some companies to focus on operational patches to achieve short-term PCs rather than long-term performance, and that this low rate is unlikely to be sustainable in the future without a negative impact on resilience and on service levels. This finding is reinforced by more recent working our own paper '**Resilient essential services require healthy assets**' and the report for Water UK on '**Options for a Sustainable Approach to Asset Maintenance and Replacement**'. Costs are likely to need to increase to keep pace with base service levels.

Benchmarking – including external benchmarking – has a part to play in assessing enhancement costs. These can be more challenging for enhancement costs where new requirements need solutions that have not been deployed before, or where the circumstances and resulting costs are often bespoke. For example, at PR24 higher standards for P removal will mean that these costs cannot easily be compared to PR19 costs. We would expect that even where cost benchmarking can be used, this will need to be supplemented by an engineering assessment to understand the additional factors that drive the efficient solutions and the efficient cost differences across companies. For any new benchmarking models, we would expect Ofwat to explain why it is more effective at identifying efficiency challenges than other methods.

Ofwat's response to a separate challenge on bioresources efficiency does not address the concern that it risks setting an unachievable challenge which is too heavily influenced by differences in the way companies allocate costs across activities. The comparison with retail is not relevant, as retail costs are more separate and less influenced by historical decisions. There is no analysis of cost substitution, and we do not think it would be efficient for Ofwat to use separate controls to drive a single set of behaviours and processes across all wastewater companies. It is possible to create

separate network and bioresources cost models but use the aggregate to set the upper quartile challenge, which is then allocated to the separate controls (as it was at PR19).

We support the proposal for transition funding in 2023/24 as well as 2024/25 to make an early start on the PR24 statutory requirements set out in companies' final WINEP. This is necessary to provide some early certainty and avoid challenges delivering a much larger enhancement programme in 2025-30. Ofwat should confirm this in the final methodology and consider if it could make early decisions in principle (for example, for 80% of the funding) to allow companies to make such an early start.

We suggest some changes to the criteria for transition funding, including modifications to existing criteria (our suggested changes in italics):

New or modified criteria	**Rationale**
"the investment has early statutory deadlines in the next regulatory period *or before 2025*"	Some WINEP requirements being set now might be needed before 2025, with indications that this could be the case for some drivers.
"the expenditure relates to early design and planning of large, non-routine investments *including programmes where this could improve deliverability*"	Larger programmes, such as addressing storm overflows or nutrient neutrality, could be started early to make sure that these could be completed in 2025-30. This should include investments under WRMP which are now needed rapidly due to abstraction licence reductions.
"*the investment provides early data to support more alternative solutions for the long-term, including nature-based solutions*".	An early start for alternative solutions, including nature-based solutions, would give more data to support the assessment of these solutions in 2030-35 (rather than just having 2025/26 onwards).

Some of our WINEP schemes in particular have co-funding from other parties, including long-term partnerships. Co-funding schemes is often beneficial for customers, but there is a risk that our partners are not able to provide this funding in practice – we would welcome Ofwat's view on how this risk might be managed in setting their expenditure allowances and mechanisms, to avoid inadvertently penalising companies. In some cases, the co-funding is not measured in £m, but might instead be the provision of land, labour, or expertise that would then need to be sourced elsewhere.

Q6.2. What are your views on how we can best align the treatment of third-party costs and revenues?

On third party services, we agree that the current approach is complex and disincentivises the provision of additional services that benefit third parties. It is also open to possible mis-forecasting incentives and cross subsidisation by principal customers. The present complex approach to third party services is a mix of three allocations of revenue and costs – 'within price control', 'outside price control appointed' and 'non appointed' (RAG 4, income categorisation).

Third party services within the price control (for example, non-potable water supply)

There is currently a disincentive for companies to provide additional profitable services in third parties within the price control, as the fixed revenue cap does not adjust upwards for the extra revenue and there is no totex sharing of the extra costs (the forecast costs are included, but fixed).

Provided the additional revenue covers the additional costs (as it should and can be checked), then there is a case for a 100% cost sharing rate for these services, as other customers are protected by the additional revenue being greater than the costs (they are likely to gain from the profit share). Making sure principal customers are protected from cross subsidising third party services could be checked by Ofwat in the APR tables (in a single third-party revenues and costs table, with a cumulative approach taken across the five-year period).

The current approach leaves companies with an incentive to over-forecast third party costs in their business plans (which are not challenged in the cost models) and retain 100% of the underspend.

Third party services outside the price control, Appointed (for example, bulk supplies)

The projected income from these services is deducted from the revenue requirement at each Periodic Review. The costs are excluded from the cost sharing calculations but are allowed in the totex allowances.

As such, there is an incentive for companies to under-forecast this projected income but over-forecast the costs in their business plans.

One solution might be to bring these services within the annual in-period price control, with 100% cost pass through. This would allow all third party in-period unforecast revenue and cost variations to be captured, removing any incentives for mis-forecasting in the business plan.

Overall approach for third party services

One other possible solution to this is to deregulate third party services entirely. This would remove the incentives for mis-forecasting and improve the incentives for beneficial expansion of third-party services.

We agree that third party services should be self-financing. As such, Ofwat could exclude both third party costs and income from the price control completely, removing any need to fix the forecasts at PR24 or adjust for variations in levels of income and costs.

This would need to be caveated by a general charging requirement for companies to set cost reflective charges for any third-party services that are uncontestable, to protect the customers receiving those services (which could be done through charging rules). In this way, all third-party services could be treated the same way as is proposed for on-site developer services.

Third party costs currently do not receive a cost challenge and do not fit any cost model, with forecast costs being automatically included in the totex allowances. Deregulation with appropriate charging rule protections would not affect water and wastewater customers and would in fact protect them from contributing towards any forecast and funded third party costs that did not materialise.

Q6.3. Do you agree that companies that submit the most stretching and well evidenced business plans should receive the most favourable cost sharing rates at PR24?

We do not agree with the proposal. We welcome cost sharing rates that are closer to 50:50, and more in line with those used by the CMA (paragraph 6.81 and 6.107).

Cost sharing rates seek to address the weaknesses in forecasting costs (for both Ofwat and water companies), sharing this risk between companies and customers. In addition, they share some of the risk of cost shocks and control the size of the efficiency incentives for companies to reduce expenditure (sharing some of the benefits and risks with customers).

Given these objectives, we see no rationale for asymmetric cost sharing rates as risk sharing and efficiency incentives are just as important whether a company is over/underspending (which they might not know until the end of the period). We therefore agree with the CMA that incentives should be symmetrical, or close to, and any asymmetries will need to be compensated for elsewhere in the package and can promote undesirable behaviour (for example, the PR19 approach incentivised submission of low forecasts rather than efficient ones). It is important that the aim for PR24 should be efficient business plans rather than the most stretching as this best meets the needs of customers and makes sure services are deliverable without undue risks. Stretching plans that are not deliverable do not help Ofwat to set a well calibrated efficiency challenge – only a less well targeted one.

The most efficient, ambitious companies in the sector could still receive an inadequate rating and receive the least favourable cost sharing rates (if, for example, they do not agree with Ofwat's proposed WACC). Compared to previous price reviews, where the cost sharing rates were linked directly to company cost forecasts in their business plan, this is a weaker incentive (that is, there is no longer a direct ex-ante business plan incentive).

We note that 2.5.1 of Appendix 9 says that Ofwat will retain the option for companies with poorer plans to attain more favourable rates if they improve their business plans by the end of the PR24 process – with a "high bar and the overall package of business plan incentives that these companies receive will be poorer than those who provided their best plan in their first submission". We support business plan incentives that continue through the whole review. Our response to questions about the business plan incentives discuss this in more detail, but Chapter 12 does not discuss how this would work.

On business rates, the CMA set a cost sharing rate for business rates that allowed companies to recover 90% of the costs in excess of its PR19 allowance or allow customers to recover 90% of the costs below this allowance, reflecting the high extent to which these are outside management control (a 90:10 sharing ratio). Ofwat has not considered this or reflected this in the methodology consultation, and nor has it explained why the CMA evidence should be disregarded. Business rates are to be set on a three-year cycle, with revaluations planned for 2023, 2026 and 2029, which means that they cannot be accurately predicted for 2025-30. Setting a fixed allowance with a stronger cost sharing rate will just give rise to windfall gains/losses and place unnecessary risk on companies – these impacts are not in customers' interest. We consider that the rates set by the CMA are more appropriate given our lack of control over them and that Ofwat should revisit its approach.

We see a similar picture for abstraction charges, where the EA is likely to review charges at least once during the price review period. Water companies have no control over these charges, so a 75:25 cost sharing arrangement remains appropriate. For NWL, the CMA recognised the "**atypical abstraction costs associated with the Kielder Transfer Scheme**" (para 14.14) and included a 100% pass-through mechanism for these costs, recognising that these costs are determined in accordance with a binding contractual arrangement. We do not consider these circumstances have changed and that a similar mechanism remains appropriate for PR24 to make sure we can recover our efficient costs and our customers pay no more than is necessary.

Q6.4. Do you agree that resilience enhancement should be used to fund companies to manage increasing risks to specific hazards that are beyond their control and not covered by base expenditure and other enhancement areas?

Base expenditure includes resilience at historical levels, and welcome Ofwat's confirmation that companies can provide evidence through the cost adjustment claim process where the historical cost base does not reflect future needs. We suggested that this type of approach might be needed in our discussion paper about regulating for the long-term.

Base expenditure does not include climate change adaptation, where we expect the risk to change over time. Although long-term planning frameworks such as WRMP and DWMP address general long-term capacity constraints, they do not address the impact of extreme weather events (which will increase over time with climate change). Similarly, the base cost models do not include cost drivers that capture this increasing impact of climate change and how it affects companies differently. Ofwat has explicitly included investment for removing single points of failure within enhancement expenditure, if these allocate a proportionate amount to base expenditure to reflect improvements to resilience against maintenance failures.

Q6.5. Do you agree with our proposed approach to setting performance commitment levels at PR24?

We do not agree with Ofwat's assessment of baseline performance levels for 2024/25. There is not enough evidence to suggest that companies will meet their PCLs in 2024/25, which are more stretching than 2020/21. Ofwat set common PCLs at PR19 as a glidepath to upper quartile performance, which means that the stretch increases significantly over 2025-30.

For Ofwat to meet its duty to enable an efficient company to finance its functions, PCLs must be set at the level for a reasonably efficient company. If the sector substantially underperforms the 2024/25 PCLs, this suggests that this objective was not achieved at PR19. It would seem unreasonable to "seek root cause evidence that there are external factors that could not have been foreseen at PR19", when it would be more likely that the PCL targets were set too high or that expenditure allowances were too low. In this case, Ofwat should reflect on the baseline more carefully.

This problem could be magnified when Ofwat proposes to set more PCLs using comparative methods. There is no company that performs well on efficient costs and all the common PCs and choosing (for example) the upper quartile on each would result in a notional company that, in aggregate, is not realistic and achievable in practice. Ofwat would need to set a lower target than upper quartile on each PC to set a similar challenge overall. Otherwise, Ofwat would effectively be setting an increased frontier shift challenge – which would need to be compensated for by reducing the frontier shift

challenge on totex, such that the overall challenge (on both totex and service quality) is still comparable to what has been achievable in other sectors.

To help calibrate the control across PCLs and totex levels, marginal cost data would be beneficial to Ofwat and companies to make sure where there is stretch beyond what an upper quartile company on costs is able to achieve, that there is a corresponding adjustment to totex allowances to make sure the whole package is deliverable. We are working with other companies on a study to provide a set of high-quality unit costs for key PCs that we would be helpful in this space.

Q6.6. Do you agree with our view on what performance commitments should be set using common or company specific performance commitment levels?

We do not agree with Ofwat's view on the PCs that should be set using common or company specific PCLs. It is not a reasonable starting assumption to expect common levels performance from base expenditure for a number of metrics.

Enhancement expenditure has a significant impact on these PCs and must therefore be factored in the assessment. For example, a substantial part of the expenditure allowed under the Green Economic Recovery determinations had an impact in reducing sewer flooding and pollution. It would be unreasonable to assume that all companies could meet the same common PC regardless of enhancement expenditure. Similar issues also arise with measures such as PCC, where metering programmes driven by local needs will be different (as acknowledged in the Ofwat methodology with the proposed econometric model). Regional circumstances such as the water supply-demand balance will also drive different historical choices by companies, for example on leakage. Differences in historical incentives will also have an impact. Where companies have delivered improved performance funded by enhanced ODIs this will not be replicable by other companies within base funding. Similarly, where a company has had a bespoke financial ODI in the past, other companies should not be expected to deliver the same performance if it becomes a common measure in future.

There is not necessarily a one-size-fits-all target that will be appropriate given these factors. The approach should therefore recognise these important differences between companies more explicitly.

We also have concerns about Ofwat's assumption that companies will continue to improve performance from base. Historical improvements in performance do not necessarily mean that significant improvements in performance are still possible in future at the same cost. For example, successive price reviews have assumed that companies will tackle the lowest cost sewer flooding risks first, leaving this to become progressively more expensive. We are disappointed that Ofwat's methodology consultation does not consider our response and previous contributions on this, instead simply asserting that historical improvements can continue for no additional cost. The marginal cost study being carried out will

help shed light on the shape of the marginal cost curve and on the resultant totex implications of that (see our response to Q6.5).

This point also applies to storm overflows. We have already committed to an average of 20 average spills per storm overflow by 2024/25. However, as recognised by the **Storm Overflow Discharge Reduction Plan** (SODRP), further improvements to storm overflows are not funded through base expenditure. These will require substantial investment to make sure the government target is met. We would expect the PCL to be set at no improvement for storm overflows (beyond 20 spills) from base; with a substantial improvement to the PCL coming from enhancement.

Q6.7. Do you agree with our proposed approach to incentivising and funding efficient investment in reducing greenhouse gas emissions and reducing the use of storm overflows?

We agree with the approach on Net Zero, but not on storm overflows. We welcome the opportunity to present Net Zero specific investment where this is not covered in other enhancement – some schemes might otherwise not be funded. This should be calibrated with the ODI for outperforming the common PCL. It may be that in some cases, the ODI will cover the costs of improvements – this has been the case for our bespoke ODI. There are likely to be larger investments (such as electric vehicles) where the costs exceed the ODI, but where these are still needed to achieve Net Zero and are still cost-beneficial. This is where enhancement expenditure should be used instead.

On storm overflows, we have committed to reach an average of 20 spills per overflow by 2025, and our draft DWMP sets out options which all meet the UK government proposed targets. These government targets include more than the '10 spills per overflow' target, and we have followed the trajectory of improvements indicated in the SODRP for both total and high priority storm overflows.

The government's indicative trajectory is not necessarily the best approach. In some cases, it may be a better solution to treat discharges rather than reducing their frequency (and so water companies seeking a best value plan should consider treatment of sewage discharges as an alternative solution to achieve the outcome of eliminating public harm rather than reducing their frequency). We also think this disincentivises catchment and nature-based solutions by focusing on metrics relating to the number of spills, rather than the harm caused.

However, this indicative trajectory is more useful for understanding how the targets will be met. Ofwat's proposed PC of 'spills per overflow' does not consider the need to tackle high priority overflows first – the effort and pace needed to hit the indicative trajectory is likely to vary between companies, depending on how many of these are in use and how easy these are to tackle. This PC also focuses on a single target and does not consider the other headline targets (including improving storm overflows so that there is no local adverse ecological impact and reducing pathogens in bathing water).

Storm overflows beyond 20 average spills per storm overflow should be funded through enhancement expenditure, setting clear targets for 2030 for:

- % of high priority site storm overflows improved (the indicative trajectory is 38%);
- % of total storm overflows improved (the indicative trajectory is 14%); and
- spills per overflow (will vary by company, depending on the costs and benefits of the schemes to achieve this trajectory towards the targets).

A common PCL based on 'average spills per overflow' would not reflect the different investments needed by different companies to match this trajectory and would not measure performance fully. We would expect companies to reach different levels of 'average spills per overflow' by 2030 if they are meeting all the government expectations, including high priority sites. The **SODRP** sets clear expectations on wastewater companies for 2030, but Ofwat has been less clear about this (suggesting in meetings that the first specific requirement is the formal requirement in 2035). Ofwat should clearly set out its expectations for delivery of SODRP by 2030 and subsequent milestones, so that wastewater companies can create and test robust plans without apparent regulatory contradictions and uncertainty.

The PCL should be set at 20 average spills in 2025, with improvements from the baseline based on the enhancement investment plan (which would be different for each company in 2030, depending on the right trajectory towards the government target for 2050). Ofwat should not use a common PCL here.

If the ODI for 'average spills per overflow' was large enough to incentivise accelerating the storm overflows enhancement programme, it would instead risk incentivising companies to select the investment schemes that reduce the spills per overflow, rather than selecting those that tackle the greatest local ecological impact and/or bathing water targets. This would also provide a disincentive to nature-based solutions (and any other innovation), which are likely to be more expensive and riskier in the short-term.

A better approach for this would be to use a PCD. Companies would be expected to set out their targets and then deliver these three targets together by 2030. They would need to demonstrate that they have made the agreed progress towards each of the targets and sub-targets, or some of the enhancement expenditure would be returned to customers.

An ODI **could** still be used to incentivise companies to make improvements relating to poor management of the network (particularly, for example, if this penalised performance beyond 20 spills per overflow). If this ODI were based on willingness to pay or the environmental harm avoided, it would likely be very small compared to the investments needed to accelerate improving storm overflows through enhancement schemes. Ofwat would need to consider the calibration of this ODI against the PCD.

In their long-term delivery strategies, companies will set out how these measures and other targets/sub-targets will be addressed through to 2035, 2045, and 2050.

Q6.8. Do you agree with our proposed approach to implementing nutrient neutrality in the PR24 regulatory framework?

We agree with an approach to nutrient neutrality that allows non-WINEP requirements to be a non-price control activity paid for by developers.

However, setting a statutory requirement for every works to achieve the TAL (technically achievable limit) is not the best approach to nutrient neutrality. If this is brought into statutory requirements under WINEP, and Ofwat implemented PR24 as planned, there is very limited environmental improvement expected – and disproportionate costs and greenhouse gas emissions. There would be almost no scope to charge developers for the impact of growth on nutrient neutrality (as this would be mostly statutory).

A better approach to nutrient neutrality is to consider this over the catchment, rather than 'end of pipe' treatment at each works. Our initial assessment in the Tees management area suggests that offsetting growth in marine areas using a catchment-based principle rather than end of pipe treatment at each works is likely to get the protected area to favourable status more quickly (and so removing the nutrient neutrality obligation). This would mean using nature-based solutions, which might include seagrass, saltmarsh or native oyster restoration, or seaweed and shellfish farming.

We'd like Ofwat to encourage the government to consider enabling this sort of approach, rather than TAL. This would be a better value solution. The North East is most affected by nutrient neutrality, with 29% of new housing delivery affected (compared to less than 3% in the North West, Midlands, and Yorkshire). If the TAL approach is used, customers in the North East will pay a disproportionate amount in their bills.

We are already engaging with Ofwat and other regulators on this, as we can see that a catchment-based solution could achieve the aim more quickly, more effectively, and deliver much more public value too. It would be unreasonable to see this solution disregarded.

We also note that it would be possible for Ofwat to set connection charging rules that allow for the cost of nutrient neutrality to be recovered from developers, even for schemes included within WINEP. This would appropriately allocate the costs of offsetting growth and allow for incentives to be included within charges (for example, we could offer a reduced charge for properties that are designed to use less water, as this would reduce the costs of nutrient neutrality and other investment).

Ofwat should confirm the approach in the final methodology, so that all business plans assume that there is a statutory requirement to go further than current environmental obligations on nutrient neutrality. This would allow consistent comparisons (and these schemes could be taken out after submission if necessary). Table DS8 allows this to be done by Ofwat if necessary, and they should build models that allow this flexibility. We note that table DS1 should include a line for contributions relating to nutrient neutrality.

Q6.9. Do you agree with our proposed approach to encouraging companies to deliver best value through our cost assessment?

We support the use of 'best value', and we will use this approach for DWMP, WRMP, and our enhancement expenditure in the PR24 Business Plan. We will use customer valuations for ODIs and guidance from WINEP to achieve this.

The methodology isn't clear about how best value should be applied. For example, 6.11 suggests that benefits such as public health, well-being and recreation should be included – but 6.1.2 says that these should not be a material driver of overall costs, consistent with the WINEP guidance. This means that this approach does not substantially extend the range of wider environmental and social benefits that are considered for optimising investment plans.

We will need to optimise our best value plans before the indicative ODI rates are available, including for WRMP and DWMP. We will use our own research to do this optimisation, substituting the central ODI values once these are available.

Q6.10. Do you agree with our proposed approach to removing the potential disadvantage that nature-based operating expenditure solutions may face in relation to the treatment of enhancement operating expenditure?

We agree that this should be removed. It would be sensible to capitalise the net present value of the whole life opex and add this to RCV. This would be a natural step to take after moving to totex at PR14, which sought to tackle this issue at a smaller scale. This meant that companies already do have flexibility to tackle this problem if all the capex and opex falls within a single price control period, through adjusting pay as you go rates (PAYG). The fact that we are now seeing schemes that create this challenge shows the success of the totex approach.

Ofwat prefers 'natural' PAYG rates. However, using these undermines the benefits of the totex approach – natural rates are functionally identical to simply using capex and opex.

We suggest some possible solutions to these challenges that avoid the perverse incentives of companies pursuing solutions that maximise company/shareholder value rather than customer value. The aim of these should be making sure that it would be NPV neutral for a company to choose an opex or capex solution (if they cost the same), as this will avoid

the distortion of incentives towards capex solutions. Without this there is a perverse incentive for worse outcomes for customers and the environment.

Cost sharing and reconciliation

This could be addressed by separating the opex for future periods entirely. For example, if a scheme cost £1m per year for thirty years, for a total of £30m. Ofwat could include £5m of opex in cost allowances for PR24, and make a separate adjustment of £25m to RCV (rather than doing this through including this as capex in the cost allowance).

The actual spend of £5m of opex in the 2025-30 period would be compared to the £5m of opex included in cost allowances, and would show no underspend, allowing cost sharing to work as intended. In future periods, the £1m per year opex could be reported on separately to other opex (as we do already for non-appointed costs, for example). The run-off rate used in the revenue allowance could have a small manual adjustment to release the RCV value in line with the opex.

The £25m of additions to RCV would then begin to earn a return from 1 April 2030. This would mean companies were earning a return on opex that had not yet been incurred, which would not have happened if this was included in the next five AMPs as opex. This £25m could be added to the RCV at a discounted value on an NPV basis to reflect this. This would then mean that companies have the right incentives to choose the right solutions based on costs and benefits to the customer, rather than distorted incentives created by the regulatory framework. It is important that the addition to the RCV is committed to so that companies have the confidence to pursue the solution rather than the "safer" capex alternative where no commitment is required.

Double funding risk

This is easily solved if the £1m of opex per year is reported separately: this could just never be included in the enhancement opex lines used in setting cost allowances, and so will never be included in base cost models. A reporting category of "operating costs funded by a RCV allowance" would be required.

Impact on financial metrics

PAYG rates can do this now – this would not have a different impact to capitalising opex in each price review period independently. As discounting is not required, there would be no concerns about the PR24 allowed return remaining the appropriate discount rate. Financial ratios may need to be adjusted slightly to reflect the new "operating costs funded by an RCV allowance" line, like the treatment of retail allowances.

Green Recovery

Ofwat does not discuss the impact of Green Recovery determinations on comparisons between companies. Ofwat allowed expenditure for improving river quality, reducing flooding, improving bathing water, achieving Net Zero, smart metering, replacing supply pipes, water quality improvements, water treatment works upgrades, water efficiency, lead pipe repairs, storm overflows, 2025-30 WINEP, and resilience.

Ofwat should account for these expenditure allowances within PR24 models, as without these determinations these would have been assessed at PR24. For example, when comparing enhancement expenditure or committed performance levels, the improvements already allowed should be included within the comparison.

In Appendix 9, Table 4.1, Ofwat sets out the basis for setting performance levels that companies can deliver. This includes sewer flooding, operational GHG emissions, pollution incidents, and storm overflows. These were included in the Green Recovery determinations – using the framework for assessing enhancement expenditure.

This suggests that these PCs are not funded from base expenditure. Other companies should be compared on performance levels excluding the Green Recovery benefits, and PCLs for Green Recovery companies should be set considering the additional benefits from these schemes. This should be the case for enhancement expenditure too.

Ofwat should consider how it will deal with Green Recovery expenditure and benefits at PR24, to make sure that all companies have consistent allowances under comparative assessments. This is not discussed in Appendix 9 of the methodology consultation.

Real price effects

An area of the methodology consultation that received very little attention was around real price effects. The evolution of costs for key items such as infrastructure delivery, power and chemicals has significantly exceeded CPIH growth. There needs to be a significant overhaul of the approach to RPEs at PR24 to ensure that key cost pressures are reflected in companies' allowances. Recent evidence clearly shows for example, that large changes in power costs are unpredictable and cannot be mitigated by companies in the same as they cannot be mitigated by households where government has intervened to supports some households with their bills.

We do not see a greater reflection of RPE pressures for different inputs as a controversial issue. All of **Ofgem's RIIO-2 price controls** include RPE indexation for different types of inputs, including the recent draft determination for electricity distribution where it included the following indices:

Table 67 Proposed RPE input price indices and weightings

Index	Weightings
Labour costs (general and specialist)	100%
AWE: Private Sector Index: Seasonally Adjusted Total Pay Excluding Arrears (K54V)	33%
4/CE/01 Civil Engineering Labour	33%
BEAMA Electrical engineering labour	33%
Materials costs	100%
3/58 Pipes and Accessories: Copper	25%
3/59 BCIS PAFI Pipes and Accessories: Aluminium	25%
3/S3 Structural Steelwork - Materials: Civil Engineering Work	25%
FOCOS Resource Cost Index of Infrastructure: Materials	25%

Including RPEs in this type of manner protects both customers and companies as it ensures there are no windfall gains/losses from unforeseen cost pressures which could be higher or lower than CPIH. Including such an adjustment also does not undermine efficiency incentives as the allowances are still set independently from companies' expenditure choices meaning that there are no undesirable impacts.

8. ALIGNING RISK AND RETURN

Q7.1. Do you have any comments on our approach to the overall balance of the PR24 incentive package, our proposed guidance on producing risk ranges, and our view of the balance of risk facing the notional company?

We agree with the Ofwat statement that PCs and benchmarks for the notional company should be set at achievable levels and should not knowingly embed asymmetry suggestive of expected penalty or reward (App10, p3). The consultation goes on to say that 'where we identify that asymmetry of incentives is liable to skew returns at the level of the overall package for an efficient company, our preferred approach is to address this through recalibrating the incentive(s) in question, rather than by an adjustment to the allowed return on equity.' Again, we support this approach albeit that the package as a whole must constitute a 'fair bet'.

However, we do not consider that the PR24 proposals, as set out, arrive at a symmetric balance of risk and reward that would make this possible and either the package needs adjustment, or a further adjustment is needed elsewhere in the overall package. Ofwat sets out its provisional view of the PR24 RORE risk range as set out in Table 1.1 (App10) but this analysis is flawed as it uses 2015-20 performance rather than the more recent 2020-22 performance that reflects the newer and more consistent methodology that was used at PR19 versus PR14. The 2020-25 performance data will better reflect the stretching PR19 Final Determination allowances that Ofwat intends to continue to PR24.

We have compared Ofwat's table to the actual 2020-22 RORE values taken from Table 1F of the APR.

Figure 5: Comparison of Ofwat's proposed PR24 risk ranges with 2020-22 performance

Actual returns and notional regulatory equity			2020-22 Table 1F		
Ofwat Table 1.1 v Actual 2020-22	P10	P90	Average	Lowest	Highest
Business Plan incentive	-0.30%	0.30%	0.00%	-0.30%	0.30%
Totex costs	-1.10%	1.10%	-0.21%	-4.81%	1.76%
Retail costs	-0.20%	0.35%	-0.61%	-2.97%	1.43%
ODIs	-2.00%	2.00%	-0.42%	-1.91%	1.50%
Financing	-0.75%	1.05%	-0.11%	-4.79%	2.98%
CMEX & DMEX	-0.60%	0.45%	-0.01%	-0.25%	0.30%
Revenue incentive	-0.05%	0.00%	-0.02%	-0.05%	0.00%
Total	-5.00%	5.25%	-1.38%	-15.08%	8.27%
Actual best/worst company				-6.77%	4.43%

We can see that the industry performance 2020-22 is skewed to the downside for totex costs, retail costs and outcome delivery incentives. Even financing costs are skewed to the downside, despite the temporary higher inflation in 21/22 generating higher financing returns.

This outcome is unsurprising where there are multiple downside-only adjustment mechanisms (such as CRI) and the proposed PR24 removal of deadbands on those mechanisms increase the downside risk. There are also new asymmetric incentives (such as BR-Mex) and the removal of many of the bespoke measures which, based on current performance are also likely to increase downside risk.

Notional risk ranges

While the use of a notional company can be helpful for normalising industry wide metrics, such as gearing and RORE comparisons, it must always be a position that can be achieved by a real efficient company and based on actual performance data. Otherwise, Ofwat risks regulating for a virtual company that performs the way that suits its theoretical assumptions and not for a real efficient company.

The consultation states:
"We propose that company risk ranges will be considered as an input into our in-the-round assessment of notional risk ranges, which is likely to draw on a range of sources". (p5)

The consultation does not state what these 'sources' will be – this should be made more explicit in the Final Methodology. This should draw on evidence collected from actual industry data and company experience in the first instance.

Q7.2. Do you agree with our proposals on the regulatory regime for managing companies' exposure to uncertainty over 2025-30?

We support the continuation of the reconciliation mechanisms set out in Appendix 13, Table 2.1.

While we support revenue reconciliation mechanisms to correct for year-on-year variations between actual and allowed revenues, we believe that the asymmetric penalties for revenue variations are unnecessary.

In our view, companies always try to forecast revenue accurately and the net present value approach taken in the models makes sure there is no incentive for them to do otherwise. So, the forecasting penalty becomes a penalty for not foreseeing a revenue impacting event they have no control over, such as a dry or wet year (changes in metered revenue), or a major industrial customer expanding/closing. It is not clear to us how it is in customers' interests for companies to

face penalties for revenue variations that are automatically corrected for in future years in a present value neutral way (see also Q3.6).

Q7.4. Do you agree with our proposed approach to setting the allowed return on equity?

We do not support Ofwat's proposed approach to setting the allowed return on equity at PR24. As we, and most of the sector, have highlighted extensively in previous consultation responses: the proposals do not reflect sound economics or finance theory; they will be damaging to the financeability and investability of the sector at precisely the time when significant investment is being sought to deliver service improvement to customers (and so put that investment at risk); and they represent a complete rejection of the position reached by the CMA panel in the longest and most rigorous review of these issues carried out in the water sector since privatisation. This should be taken extremely seriously, as the proposals disregard those decisions made by the CMA within the framework which Parliament established to arbitrate these matters – and the proposals do not reasonably allow Ofwat to meet its statutory duties in this area. Ofwat provides almost no new evidence to support the positions it has reached and does not engage sufficiently with the evidence provided by the companies.

We, alongside almost every other company in the sector, have commissioned a range of reports that provide genuine new evidence and commentary on the correct approach to setting the allowed return on equity at PR24. These have covered issues relating to the key parameters of the cost of equity calculation and collectively support the approach set out by the CMA in its most recent redetermination of these issues. We have submitted these reports to the Future Ideas Lab, and they are published on the Ofwat website. We summarise the key findings from these reports below.

Risk Free Rate – Convenience Yield

We are disappointed that, despite Ofwat referencing four academic studies that all recognise that a convenience yield exists, reaches the conclusion that, because it is 'difficult to implement', no adjustment is appropriate. (App11, p7).

We remind Ofwat that both the PR19 water determination and the energy appeals both recognised the existence of a convenience yield. Indeed, the **Ofwat Risk & Return consultation** (Dec 21) acknowledged this and stated: "We intend to carry out further work to better understand this issue." We look forward to the publication of this work, and request it is published before the final methodology to give companies opportunity to review it.

In reference to uncertainty over calculating the value, all market data used for the CAPM cost of capital components have a range from which Ofwat will choose a fixed point for the determination. We do not see why estimating the convenience yield should be any different. A central estimate is always more appropriate than ignoring a value because it is uncertain.

Moreover, we do not consider that the adjustment is 'difficult to implement' because an approach has already been undertaken by the CMA **and more recently the CAA in its H7 decisions** (p53).

Risk Free Rate reports

As part of our range of reports, we commissioned two reports on the Risk Free Rate. These provide a review of Ofwat's proposed approach, presenting alternative approaches where these are appropriate. We include some key extracts from these reports below but we support the conclusions of this work, in particular that:

- A convenience yield exists and is potentially larger that Ofwat is suggesting;
- That it is right and 'prudent' to look beyond the use of index-linked gilts in setting the risk free rate to reflect the 'specialness' of ILGs; and
- That there are simple and practical approaches to reflecting the convenience yield such as that adopted by the CMA and the **CAA in its most recent regulatory decisions**.

First Economics – Risk Free Rate: Section 2: Calculating the risk free rate (extract)

"In these circumstances, we think that it would be prudent for a regulator to look beyond just index-linked gilts to a wider basket of proxies for the riskless assets. We note that this is not a novel idea – the possible other ways that there are of obtaining estimates of the risk-free rate have been discussed at length over a period of many years due to long-standing concerns about the "specialness" of index-linked gilts compared to other assets.

"The most recent, substantive contribution in this area came from the Competition & Markets Authority (CMA) in its PR19 determinations. In its report the CMA identified both a theoretical and a practical rationale for estimating the risk-free rate using basket of assets comprising index linked gilts and AAA rated non-government bonds. We are aware that Ofwat disagreed/disagrees with some aspects of the CMA's reasoning, but we would suggest that the margin of error in an index-linked gilts only methodology is now far greater than the margin of error that arises from using additional proxies, for the reasons set out in the preceding charts and tables."

Oxera – Risk Free Rate: Executive Summary

"Finally, we provide our estimates for the RFR for PR24, at between -1.22% and -0.96% (CPIH-real), with a midpoint of -1.09% as at July 2022. Specifically, we set the bottom of the range as the **six-month trailing average of the UK 20-year ILG,** and the top of the range **as the six-month trailing average of the iBoxx £ non-gilt AAA 10+ and 10-15 indices**, as at July 2022. As stated by the CMA, this approach is a more pragmatic and simpler way of estimating the RFR, which avoids quantifying the convenience premium in the bottom-up approach and adjustments to AAA bond yields in the top-down approach.1 This updated approach also implicitly allows for the convenience premium, by setting an RFR above the ILG yields.

"Our updated RFR estimates are based on our estimate of the RPI-CPIH wedge, of 56bp. We show that Ofwat's proposed methodology for estimating the wedge, 'the official forecasts', significantly underestimates the 'true' RPI-CPIH wedge by omitting the CPI-CPIH wedge and overlooking the ongoing uncertainties surrounding the transition from RPI to CPIH planned for 2030. We present a more robust and market-based estimate of the wedge based on RPI swap rates, CPI swap rates and the historical CPI-CPIH wedge."

Notional Gearing

Ofwat's proposed choice of a notional gearing level below 60% is arbitrary, subjective, and not based on regulatory precedence or market data. We set these arguments out comprehensively in our previous responses to Ofwat's earlier consultation and so do not repeat them here[6].

We agree with the observations made by Frontier Economics in its report (in the Future Ideas lab) which is consistent with our own previous response. In particular:

- There is no clear basis for adjusting the level of notional gearing as Ofwat is proposing. There is neither a strong theoretical or in principle argument nor is there reasonable market evidence to support such a change where industry gearing and levels of leverage in other regulated sectors and competitive infrastructure industries are generally much higher than the level proposed suggesting that the efficient capital structure is higher than Ofwat is suggesting;
- Even if additional headroom were to be required Ofwat has not provided any evidence to support a decision as to why adjusting the notional gearing level is the right approach rather than some alternative tool; and
- Adjusting notional gearing in a large way as is proposed is not consistent with stable and predictable regulation and will create costs for customers where companies must adjust their capital structure over time.

Excerpt from Frontier Economics – Notional Capital Structure - Executive Summary

"We ***have reviewed Ofwat's proposal to lower the notional gearing level from 60% and conclude that it does not satisfy Ofwat's own notional gearing framework, nor is it supported by empirical evidence.***

"The relevant market metric is regulatory gearing. Gearing ratios based on enterprise value (EV) are not relevant to financeability.

"The current notional gearing level of 60% is already at the bottom end of the range implied by market evidence. There is no evidence to justify reducing it below current levels.

"The market evidence across credit rating agency criteria, actual gearing rates, and regulatory precedent supports a range of 60%-75%. The current notional gearing level of 60% is therefore already at the bottom of this range.

[6] See: https://www.ofwat.gov.uk/wp-content/uploads/2021/12/NES-Risk-and-Return-Responsed.pdf pp.12-13

"Even if additional headroom were required, Ofwat has not justified why lowering the notional gearing is the best option.

"As Ofwat recognises in its draft methodology, credit ratings are based on multiple factors. Regulatory gearing only has a weighting of 10% in Moody's rating methodology and Ofwat has not provided evidence that it has considered other options for providing necessary headroom which may be more effective. Other regulators have considered alternative solutions to address uncertainty from factors such as increased risk of extreme weather. For example, Ofgem's draft determination for RIIO-ED2 includes a severe weather funding mechanism, as well as severe weather allowances and re-openers. We recommend that Ofwat works with companies to understand the root cause, scale, and balance of any additional uncertainty and use this to assess solutions in the round.

"Without clear market evidence and supporting assessment in the round, changing the notional gearing level risks undermining investor confidence and goes against regulatory best practice.

"The government's recent review of economic regulation has highlighted the importance of stability in the regulatory regime to support long-term investment. This is key given that the water industry is likely to require significant investment in PR24 and beyond. Lowering the notional gearing rate without supporting evidence is likely to reduce investor confidence due to higher perceived regulatory risk. This in turn will undermine Ofwat's original intentions to support investment in the sector and may be perceived as counter-intuitive given the role of debt investment over the life of new assets.

"While Ofwat argues that a change of up to 5% would not be unprecedented based on historical gearing levels, these should be considered in the context of the wider financial and regulatory environment and, in particular, the growth of RCV relative to annual costs over the past 30 years. This means that relying on historical gearing rates alone is not sufficient to argue that a change today is precedented, particularly as Ofwat has provided no empirical data or evidence to justify moving away from 60%.

"In summary, we have seen no significant evidence to support a move away from the current 60% gearing level which already lies at the bottom of the reasonable range informed by market data. Nor have Ofwat provided an impact assessment to demonstrate that a reduction in notional gearing levels is beneficial for customers, particularly as any change in gearing levels will have associated costs including equity issuance cost and tax liability impacts.
Without this evidence, there is a real risk that a reduction in the notional gearing level will mean companies are incentivised to move to inefficient actual gearing levels. This would lead to several adverse impacts including undermining investor confidence, over-reliance on a single source of financing, and equity issuance costs which ultimately need to be borne by customers."

Betas, Levering & Delevering

We have commissioned a KPMG report on the Betas, Levering and Delevering. This has been submitted to the Future Ideas lab. The First Economics paper on the risk free rate also covers this issue in Section 3.

KMPG Relative risk analysis and beta estimation for PR24

Setting beta based on a long-run investment horizon

We agree with KPMG's view that a long-term approach should be taken to estimating beta, in particular considering adjusting for the weighting of the short-term impacts of Covid-19 and the Ukraine war. The CMA also removed atypical data from its assessment for PR19 related to the Covid period.

KPMG note that "The adoption of a long-run horizon is consistent with Wright et al (2018), who recommend use of a long-run time horizon because regulatory assets tend to be long lived. This Report assumes based on asset lives an investment horizon of at least 15Y in line with the horizon reflected in Ofwat's draft methodology.

"The chosen time horizon should be specified clearly and estimation of each parameter in the WACC should be carried out through the lens of the chosen time horizon, as far as possible, as otherwise the WACC estimate is not a true expected return over the chosen time horizon. This is a key assumption as reflecting short term variation in betas – such as variation observed in relation to Covid-19 and the war – may not be reflective of risks and return requirements over the selected long-run investment horizon, would not be consistent with the basis for estimation of other parameters such as the risk free rate and in turn might not attract long-run capital to the sector."

Assessment of how risks are expected to change at PR24 relative to PR14 and PR19

We believe that Ofwat's approach for PR24 increases risks in the ways set out in the report. Although the PR24 approach is not yet fully set out, the proposal not to protect the post 2020 Bioresources RCV through the regulation of 'gate fees' is potentially a significant new risk.

KMPG states: "The analysis indicates that are a number of risks which are likely to increase on a forward-looking basis, which all else equal are likely to increase systematic risk. This includes step changes in investment to meet environmental obligations for example in relation to storm overflows, population growth, the transition to Net Zero (which all increase deliverability risks), increased competition (which increase the risk of asset stranding) and more stretching performance targets (which increase the risk of regulatory penalties)."

Approaches to de- and re-levering beta - Ofwat's proposal to adjust the debt beta

We agree with the conclusion of the KPMG report stating that the proposed approach of adjusting the debt beta to solve the gearing MM issues could compound an existing issue which is already resulting in under-estimation of required returns. As a result, the preferred approach based on the analysis in this Report is to retain the current approach to de- and re-levering.

Below we also quote the conclusions of the First Economics work.

First Economics: Section 3, The Risk-free Rate, Debt Premium, Debt Beta and the Effect of Gearing, Conclusions

"A debt beta of 0.216 pushes at the boundaries of plausibility. A debt beta of 0.30 goes well beyond the estimates that one can find in academic literature or in use among practitioners for a modestly geared company with investment-grade debt. The conclusion that we draw from the preceding analysis is that the problem that Ofwat has identified is not, in fact, likely to be the product of a faulty debt beta selection, but rather it is much more likely to be bound up in the issues that we presented in section 2.

"We set out in table 9 two alternative ways of updating the PR19 cost of capital calculation to incorporate data as at 1 April 2022. Both approaches give broadly equivalent estimates of the cost of capital at 60% and 54.2% gearing respectively. "But our strong view is that the second set of parameters is a much more coherent representation of the prevailing debt premium paid by companies and the prevailing debt beta, each of which is in turn anchored by a much more realistic characterisation of the prevailing risk-free rate of return."

The use of Market to Asset Ratios (MARs)

We agree with the **CMA's conclusions** (para 9.1362) that MARs analysis can be influenced by a wide range of factors and controlling for those factors to identify any real premia or difference can be extremely challenging. We also note that the **previous UKRN work**, including by Ofwat's own academic advisors, also recognised some of these issues. We therefore do not consider that MARs should be used as a cross check. There are a wide range of other better cross checks that could be proposed.

We consider that there are a range of cross-checks that are appropriate in setting the cost of capital:

- Risk analysis should play an important role in providing a cross-check on the overall package including the cost of capital.
- Financeability analysis also represents an important cross check in setting the cost of equity as recognised by the CMA.
- Other cross-checks should also be used including the ARP/DRP cross-check or alternative hedge ratios and the use of multi-factor models.

We draw Ofwat's attention to the **KPMG report on MARs**: "In general, from this assessment, it would appear that there are better options than MARs for use as cross-checks on the allowed cost of equity in regulatory price control determinations. There is a risk that if MARs are used to inform the allowed cost of equity, mainly based on the most recent private transactions or from listed utilities in GB, this may be incentive incompatible and may result in the allowed cost of equity that may not facilitate investment in consumers' interests.

"Overall, the analysis presented in this report leads to the conclusion that the use of MAR as a cross-check is unlikely to assist regulators in fulfilling their statutory duties objectively."

Q7.5. Do you agree with our proposed approach to setting the allowed return on debt?

We cannot reasonably give a view on the approach to setting the allowed cost of debt as Ofwat has not explained sufficiently how this approach would be carried out. We support the use of the balance sheet approach in principle, but need further details on the averaging approach and contents. We welcome Ofwat's proposal to share the models on each company's data and the derivation of the sector benchmark.

As part of the calculation of setting the allowed cost of debt Ofwat proposes to exclude derivatives. We do not agree with this approach. While there may be very specific examples that could reasonably be excluded (for example, swaps that have been used purely to reprofile cashflows over time) in raising finance companies already do so competitively and where derivatives are raised it is because that is the cheapest way to raise the finance in line with the company's risk hedging strategy. For example, under current market conditions the cheapest way to raise a 15-year fixed-rate bond would be to raise a 15-year nominal bond with a derivative swap. The majority of swaps in the sector are designed to achieve economic hedges and should be included in the calculation. Taking the approach Ofwat is proposing would encourage companies to raise efficient finance as they would know that in this circumstance the swap would not be included in the calculation. These derivatives are generally included in the approach taken by the independent rating agencies in assessing companies' debt costs.

The use of an independent index as a benchmark cross-check appears sensible, but again more detail is needed to understand how this check would be carried out. We assume, for example, that Ofwat would not apply an adjustment for 'outperformance'. Such an approach was rejected by the CMA because once tenor and rating were controlled for no outperformance relative to the benchmark was found.

Ofwat's proposed approach to new debt is generally uncontroversial except that it proposes to make an adjustment for perceived outperformance. Substantial investigation was carried out as part of the CMA appeal process into whether there exists any real difference between the cost of water company debt raised, and the iBoxx benchmark index. Within this analysis all bond issuances were examined and adjusted to correct for the common tenor and rating that the index implies. Once this was carried out the 'wedge' disappeared, and the CMA did not include one for new debt (in either its draft or final proposals). It is disappointing that Ofwat makes no reference to this work which is well understood and which we cited previously in earlier responses which Ofwat has not engaged with. At a minimum, if Ofwat seeks to apply such an adjustment then it will need to show that such a 'wedge' exists with analysis that is supported by a similar level of rigour to that carried out for the CMA process. Ofwat will also need to demonstrate how such a wedge has materialised since the CMA's review and redetermination.

Q7.5 (a) Do you agree with our proposed approach for calculating the retail margin adjustment?

We do not support Ofwat's approach to calculating the retail margin adjustment. Ofwat created the 1% household retail margin to ensure that the retail business was a profitable business that was comparable to similar retail markets. Ofwat's approach in PR19 was to 'claw back' any of the 1% margin that does not relate to financing the identified fixed assets. This returns the retail business into a cost based rather than standalone profitable business. It is thus a business that is only commercially viable with the associated support of the wholesale business and does not represent a stand-alone price control, this further contributes to the 'perfect company' benchmark problem that we have highlighted previously in this response.

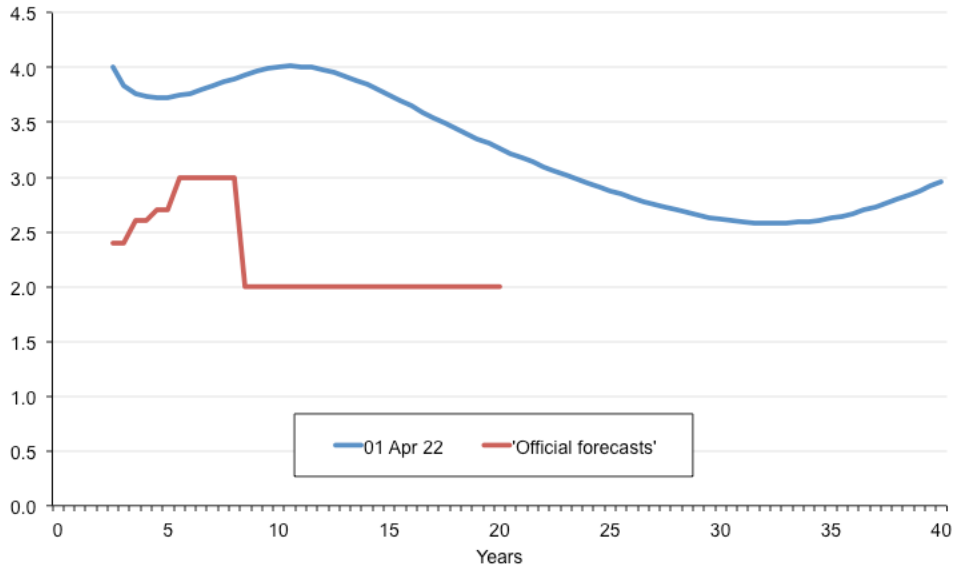
We agree that if a retail margin adjustment were needed then using the modelled working capital balances from the financial model would be a better approach than trying to calculate and use debtor and creditors days. We also agree that a pre-tax WACC should be used for the financing costs. The working capital from the financial model should include debtors, creditors, measured income accruals and advanced receipts. For PR19 these aggregated to a net working capital requirement that requires financing from the 1% margin, along with the return on the retail fixed assets, which are now wholly outside the RCV.

Q7.6. What are your views on the options we have set out for estimating the RPI-CPIH wedge for converting RPI-linked yields to a CPIH basis?

This is part of the assessment of the risk free rate, and so our response to Q7.4 covers this topic too. The First Economics and Oxera papers (Risk Free Rate, Future Ideas lab) that we linked to in our response to that question are relevant here, and we present extracts from each below. We support the approach proposed by Oxera in their report for estimating the RPI-CPIH wedge.

First Economics: Risk Free Rate, Section 2.2

Figure 4: 'Official forecasts' vs instantaneous forward inflation curve (%)



Source: Bank of England website, OBR, Ofwat.

"Figure 4 further emphasises this point by superimposing the 'Official forecasts' from table 1 onto the instantaneous forward inflation curve. Again, there is a sizeable, unexplained gap between the two lines throughout the forecast period.

"What we interpret that figure 4 to be showing is that Ofwat, in effect, is in danger of introducing a significant mismatch between market pricing and regulatory assumptions. In extremis, the risk is that Ofwat will end up imposing its own regulator-created calculation of the all-in inflation inclusive risk-free rate of return, and hence also the CPIH-stripped equivalent risk-free rate, rather than pick up a properly market-based measure of the prevailing riskless rate of return."

2.3 Conclusions

"In our assessment, the picture that figure 4 presents gives Ofwat a serious problem to work through during PR24. We can understand why Ofwat would wish to approach the conversion of yields on index-linked gilts by assessing what expectations a rational investor ought to form about the future worth of RPI inflation indexation upon reviewing official forecasts and official policy statements. However, the evidence set out above indicates clearly that something is happening in the gilt market that is pushing the prices of index-linked and nominal gilts away from what Ofwat would regard as normal economic fundamentals."

Oxera – Section 4 – Estimate of the RPI-CPIH wedge

Table 8.1 below sets out Oxera's estimate of the RPI-CPIH wedge of **63bps**, which is based on the RPI-CPI wedge and CPI-CPIH wedge shown in section **Error! Reference source not found.**.

Table 8.1 Oxera's estimate of the RPI-CPIH wedge for 20 year gilts

Component	Bps
Six month average of RPI-CPI wedge implied by 20y swap rates	46
20 year average of CPI-CPIH wedge	17
Oxera's estimate of RPI-CPIH wedge for 20 year gilts	**63**

"Note: The RPI-CPI wedge of 46bps is estimated by averaging the spread between 20y RPI and CPI swap rates over the last six months, using a cut-off date of July 2022. While **Error! Reference source not found.** presents weekly average spreads, six months average of daily spreads is used for the calculations in this table."

Source: Oxera analysis.

Table 8.2 compares CPI-real. The first uses 'official forecasts' and the second uses Oxera's estimate of the RPI-CPIH wedge.

Table 8.2 CPIH-real gilt yields as at 29 July 2022

	Calculation	Ofwat's official forecast approach	Oxera's estimate
20 year ILG yields, RPI-real	[A]	-1.07%	-1.07%
RPI Inflation adjustment	[B]	2.75%[1]	
CPIH Inflation	[C]	2.32%[2]	
RPI-CPIH Wedge	[D] = (1+[B])/(1+[C])-1	0.42%	0.63%[3]
CPI-Real yield	[E] = (1+[A])*(1+[C])-1	-0.68%	-0.45%

Note: [1] 20 year average of annual RPI inflation, based on OBR's forecast in March 2022 and assuming a transition to CPI by 2030. For 2027-2029, a long-term target of 3% is assumed. [2] 20 year average of CPI inflation, based on OBR's forecast in March 2022. From 2027 onwards, a long-term target of 2% is assumed. [3]Oxera calculation in Table 8.1.

Source: Oxera analysis using data from Bank of England, OBR and Bloomberg.

Q7.7. Do you agree with our proposed approach to the notional structure and setting allowances for corporation tax?

We agree with Ofwat's proposals to retain the position of calculating tax allowances based on the gearing that underpins the notional financial structure, or a company's actual gearing if higher. Passing on to customers of the tax gains (from higher gearing than the notional level) is a benefit to customers and would be lost were companies to be incentivised to reduce gearing by Ofwat via the Gearing Outperformance Sharing Mechanism (GOSM) or an equivalent.

We support the retention of the tax reconciliation mechanism for taxation matters outside the company's control such as tax rates and capital allowances.

Q8.1. Do you agree with our approach to assessing financeability?

We do not agree. While Ofwat requires the business plans to be financeable, the same financeability requirement also applies to Ofwat when setting the determinations. Ofwat should carry out the same stress tests on the determinations that companies are required to do in their business plans.

Ofwat only carried out one stress test in the PR19 Final Determination. The stress test results were not published, with a simple subjective statement made that: "Many companies pass this stress test, and some narrowly fail".

Q8.2. Do you agree with the focus on the metrics outlined in section 8.4 for the assessment of financeability?

We do not agree. We are concerned that, as per Table 8.1, Ofwat continues to calculate some financial metrics that ignore the ratings agencies approach. Ofwat has now integrated ratings agencies assessments into the PR24 methodology (prescribed target credit rating for the notional company) and the proposed licence amendment to the cash lock up threshold.

Having done this, it cannot be relevant to assess metrics that do not take account of the ratings agencies' actual approaches. When Ofwat does assess the financeability of the determinations, the identified 'alternative' metrics of Gearing, AICR, FFO/Net Debt and RCF/Net debt must be the ones used.

Q8.3. Do you agree with our proposed approach to cost recovery, in particular that we set a narrow range for RCV run-off rates within which companies will be required to evidence their choice of rate which best achieves a fair balance between current and future customers?

We do not agree. In comparing RCV run-off to base maintenance expenditure (per App 10, Figure 5.1), Ofwat has missed an important point - that enhancement capex assets also depreciate once they are built and need to be paid for over time. If RCV run-off were set to match just maintenance capex in perpetuity, then the original investment in enhancements would never be paid for by any customers, it would remain in the RCV forever - even after those enhancement assets were fully depreciated and replaced. This would undermine intergenerational equity, as it would defer the accumulated costs of financing all cumulative enhancement assets to future customers (and it would result in an enormous RCV that could never 'flatten out').

The correct Ofwat methodology to date (PR14 and PR19) has been to include an allowance for the depreciation of all assets, and Ofwat refers to the "assets utilised in each control" (p103) which must include enhancements. In the PR24 Final Methodology, Ofwat will need to correct the erroneous implications of the wording in page 103 (opening para) & around Figure 5.1.

In summary - we would expect RCV run-off to be higher than just base maintenance capex, to make sure the current generation of customers were paying for the depreciation of all the assets used in the service they receive.

This misunderstanding aside, a narrow range isn't needed for run-off rates if companies must demonstrate why their rate achieves a fair balance between current and future customers. This seems an unnecessary constraint to apply in advance, when the evidence will be provided and examined in any case; particularly at a time when we might expect this to change from historical trends with the increase of schemes with long asset lives across the sector (such as water resources and nature-based solutions). We expect our RCV run-off rate to fall within the narrow range in any case.

To set run off rates accurately, the most important new approach for PR24 will be for the Ofwat financial model to allow for separate run off rates for existing RCV and new investment. The former will be based on remaining lives while the latter will use full asset lives. This will better reflect asset depreciation and the charging customers for the use of those assets. This was not an option for the network controls in PR19, which had single run-off rate inputs that were effectively a mix of the two.

Q8.4. Do you agree with our proposed approach to resolving a financeability constraint?

We do not agree. Under significant real RCV growth, we are unclear why Ofwat intends to maintain a minimum level of dividends while also assuming additional equity financing. As the methodology consultation acknowledges, issuing equity has an associated cost, while varying dividends does not.

Q9.1. Do you agree with the proposed standard set of scenarios for testing financial resilience?

We agree with the eight common scenario stress tests set out in the draft methodology (Section 9.3, p111). They generally match the tests carried out in PR19 and we consider them a useful test of the financeability of the overall package, including the cost of capital.

In contrast, Ofwat only carried out one stress test in the PR19 Final Determination (p98-99 of PR19 Risk & reward FD). The stress test results were not published, with a simple subjective statement made that: "Many companies pass this stress test, and some narrowly fail" (p99).

If Ofwat believes that stress testing is important (and we believe it is), then it is critical that Ofwat carries out and publishes the results of the same set of stress tests following the draft and final determinations.

Q9.3. Do you agree with our proposed approach to dividend policies, performance related executive pay and voluntary sharing of financial outperformance?

We have a clear bonus scheme for performance related executive pay in place. Ofwat set this out as a case study in 2021:

"Northumbrian Water clearly set out the targets for each metric which made up its annual bonus scheme alongside the actual performance in the year against each metric, whether the target was achieved, and if so, the percentage of the bonus award which was payable as a result".

We support the sharing of financial outperformance through the assured and transparent reconciliation models in place for revenue, totex, cost of new debt, tax rates and outcome delivery incentives. These models are all calibrated to make sure incentives are retained, while adjusting for changes not in the control of companies. We do not believe Ofwat should intervene in any further bespoke voluntary schemes by either rewarding or penalising companies for adopting them.

9. OUR BUSINESS PLAN SUBMISSION

Q10.1. Are the PR24 submission requirements clear and sufficiently specified?

Yes, these are clear. It is unfortunate that Ofwat needs to place restrictions on innovative plans, as there is value in using other media to explain key issues.

The business plan tables will need to be specified in more detail for the final methodology, though we understand why this cannot be achieved at this stage. We appreciate the improvements to bring these much closer to the APR tables (the line references were particularly useful) and would like Ofwat to specify the same item reference numbers where possible.

Q10.2. Is any data missing, or included but not required or areas we need to look at again?

There is no missing data.

Ofwat should specify how it will use the data in each table for its analysis and decision making. For example, the detailed requirements for long-term delivery strategies seem unnecessary, given the uncertainty in the numbers at this level of detail. It is not clear how Ofwat will challenge the LTDS, beyond testing that:

- All key enhancement activities have been included in terms of adaptive pathways, with appropriate use of trigger and decision points.
- These have been tested against the common reference scenarios and wider scenario testing as appropriate.
- These are supported by robust evidence.

The data table requirements do not seem to be needed to support this decision-making process, as the tables are not needed to assess against these criteria. There is no comparative analysis proposed that would require data in a similar format, or even broken down in this way.

For each table, Ofwat should explain how the data will be used in models and/or analysis to make its decisions during the price review process. Ofwat should then publish this analysis alongside its decisions and show how the data was used.

It would be helpful if Ofwat could consider:

- Adding more tables into the financial model, and/or producing a tool to transfer data from the tables to the financial model (or vice versa). This will help to drive consistency between the two, and reduces the analytical and assurance resources needed across all companies to ensure this consistency.

- Alternative methods to deliver the information in the tables, rather than completing very large-structured tables in Excel (and we note that the tables don't yet reflect the full size and complexity of the final requirements). For example, Ofwat uses "F_output" sheets to load the data to their database that are structured much more effectively for companies to report the data from their systems. Ofwat doesn't use the tables in their "raw" form, as these are managed in a central database, so the structure of the tables should be according to the most effective method of delivering this data from companies to the Ofwat database. We are willing to work with Ofwat to help design this.

It is helpful to collect information on past performance and reconciliation models before the business plan – such as in July 2023. Ofwat should specify this, including separate tables requirements, with the final methodology. We note that some elements could shift slightly between July and October 2023, such as inflation actuals/forecasts. Some elements of past performance require more than just simple numbers and models – for example, reconciling the ODIs for per capita consumption, as set out in Ofwat's consultation.

Q10.3. Are the limits on the number and size of documents workable? Should we be more prescriptive in terms of file and folder structures etc?

There shouldn't be any constraints set on the number and size of documents. These restrictions could mean that companies don't include some evidence that they might have otherwise – it wouldn't be sensible for Ofwat to intervene just because they didn't have this evidence. Ofwat should specify these constraints as optional guidance only, encouraging companies to include evidence alongside their business plan where they think it is needed.

There is no need to be more prescriptive about file and folder structures. However, Ofwat is using a SharePoint capture site – and so could consider setting a metadata structure to help order evidence. In a simple example, files could be labelled 'main plan', 'supporting appendix', or 'supporting evidence report'. Companies could label their documents using these pre-set metadata tags, and Ofwat could then filter and navigate through documents more easily. These tags would also help Ofwat to understand where companies have included information.

If Ofwat does do this, we recommend that they require the files to be stored without subfolders. This would help search and navigation using metadata tags instead of subfolder names, and avoid technical issues with file path lengths in

SharePoint. We also note that if Ofwat sets up this metadata to be consistent with its own internal SharePoint system, then transferring files from the capture site could be much more straight-forward.

Being able to create links between our documents to support Ofwat navigating between documents would be useful. This is only possible if we know that the relationship between documents will be preserved when they are transferred to Ofwat's system. Ofwat should test this, because if companies can create links between documents this would make the assessment more efficient.

Q10.4 Do our expectations for company board's assurance and governance arrangements provide enough guidance to ensure that boards have sufficient level of 'ownership' and so ensure a high-quality submission?

Yes. We note that the definition of 'high-quality' in the methodology consultation includes the use of several Ofwat numbers (such as ODI rates and WACC) in the business plan, which is in direct conflict with ownership by company boards. It could conceivably be impossible to both use these Ofwat numbers, and at the same time provide assurance that the business plan allows companies to meet all their obligations.

Q10.5. Do you agree with our proposal to continue to apply revenue adjustments for past performance across all years of 2025-30, after the financeability assessment?

Yes. From a modelling point of view, it may be more practical to smooth total bills within the financial model rather than trying to smooth PR19 reconciliation adjustments to smooth bills. In that way, the interaction with the many other adjustments to revenue will be considered.

Q10.6 Do you agree with our proposal for 2024-25 blind year adjustments? Should we treat in period ODI adjustments in the same way as other blind year adjustments or retain the approach set out in the Rulebook?

Yes, we agree. Ofwat should set revenues for 2025-30 using forecast performance for 2024/25 in-period ODIs (and then adjust for any difference in the in-period determinations in 2025, alongside other blind year adjustments for end-of-period incentives). This is simpler and prevents larger "swings" in 2026/27 revenue (and therefore customer bills) – that's why Ofwat has taken this approach with blind year reconciliation before.

10. ENCOURAGING QUALITY AND AMBITIOUS BUSINESS PLANS

Q11.1. Do you agree with the framework we propose to encourage the best business plans?

No, we do not agree with the framework as set out in the methodology consultation. In its PR19 lessons learned report Ofwat noted that 'only one company told us it made a conscious decision not to go for fast-track status because in its view the costs outweighed the benefits'. As currently proposed, we would be very surprised if any company decided to actively seek an 'outstanding' plan.

We agree that an incentive is the right thing to do, and the logic of assessing 'quality' and then 'ambition' sounds reasonable. However, the proposed incentive is not really an incentive for high quality and ambitious business plans – instead, it requires companies to adopt Ofwat's central view of parameters such as ODIs, cost of capital, bespoke outcomes, and costs or to face substantial penalties. This is not an incentive and would drive companies to adopt Ofwat's central view rather than choosing the best plan – so stifling innovation and driving unbalanced and undeliverable business plans.

If Ofwat's central view of parameters is wrong, there is a strong risk that many companies could not create a business plan that meets their obligations, while at the same time using these parameters. This would lead to Ofwat scoring many plans as 'inadequate', so undermining the business plan incentive entirely (and likely leading to multiple CMA appeals). Ofwat does not intend to consult on the parameters (such as cost of capital) and would make decisions about business plan incentives without considering the quality of evidence or analysis in business plans. Ofwat was very open in its seminars that it would score plans as 'inadequate' unless a company's evidence about cost of capital were so compelling that Ofwat changed its view for the whole sector. As noted elsewhere in this response, Ofwat has been unwilling to consider or address this evidence while developing the methodology and its position in this area seems to be closed to evidence and discussion.

In these circumstances, the naming of the categories is inflammatory – particularly the use of 'inadequate'. This category name could be appropriate for a plan which does not meet basic quality standards and has limited ambition, where the company should rightly be called out – but it seems less appropriate for an ambitious plan, supported strongly by customers, which simply disagrees with an Ofwat parameter. This would likely lead to water company boards, customers, and stakeholders disengaging from the process and would be damaging to the reputation of the sector as a whole. Ofwat should carefully consider how to avoid labelling the whole plan – and perhaps even whole water companies – as 'inadequate', resisting the temptation to strongly criticise plans while draft decisions are still open to consultation.

We explore these issues more in this section and suggest some improvements.

Q11.2. Do you agree with the proposed scope of our 'quality' assessment?

No, we do not agree with the proposed scope of the assessment or that the proposals will incentivise 'quality' plans. The idea of assessing quality of evidence and ambition in areas like costs, service levels and risk and return is sound, but the application is wrong.

As noted in our response to Q11.1 the application of the criteria does not work and will not drive 'quality'. The proposed framework requires a company to use the Ofwat parameters in their plans. This doesn't really work as an indicator of quality and discourages the preparation of evidence-based plans, as for example:

- A company which uses the Ofwat cost of capital does not need to provide any evidence that they have considered what a suitable allowance would be, or any analysis to show that this is an appropriate or efficient level. Yet this plan would be assessed as 'good quality'.
- On the other hand, a company which had considered the evidence carefully and concluded that the Ofwat cost of capital would not allow them to finance their functions or is insufficient to cover the risk, might choose to use different parameters, showing the appropriate supporting evidence, but this plan would be assessed as 'inadequate'.

The application of this approach needs to carefully consider what is being incentivised here: is it the quality of the thought, rigour, and evidence that has gone into the plan – even if Ofwat ultimately arrives at a different view? Or is it simply an incentive for companies to use the Ofwat values? Ofwat should be clear that this is about making sure that companies provide the evidence for their view, not whether they have used the Ofwat proposed parameters (or if Ofwat agrees with the company's view). At privatisation, Parliament established independent economic regulators to encourage a rigorous evidence-based economic assessment of these things and this focus on evidence and rigour should not be abandoned.

The use of this incentive undermines the role of board in owning the business plan. If the incentive is intended to drive companies to use Ofwat values, then Ofwat should consider the impact this would have on company ownership of their plans, and on the assurance statements that company Boards must make that the business plan would allow them to finance their functions. The effective requirement to use the Ofwat parameters is in direct conflict with this requirement.

Ofwat should remove the criteria to use any of its centrally imposed parameters and instead seek the best possible evidence in supporting business plans. This ensures that a 'good quality' plan is one that includes compelling evidence that the company has considered carefully what each of the parameters should be. Ofwat could still set out its own view of those parameters and its evidence to support that view.

This is not an issue for all the quality requirements, and most are the right things to test. We were pleased to note that for example, Ofwat's view of a company's efficient costs are not included in the criteria for the quality assessment, instead focusing on testing that companies have met the requirements in how they have developed their plans (and rightly placing stretching, efficient costs in the "ambition" section instead).

Q11.3. Do you agree with the proposed scope of our ambition assessment?

No, the scope of ambition is incomplete.

We would strongly encourage Ofwat to add the track record of a company (in terms of its efficiency and service performance) into the assessment. Ofwat previously failed to apply these criteria at PR14 and added it into its assessment for PR19 under 'Accounting for past delivery', recognising its importance - but it has been removed again for PR24. These criteria allow differentiation between companies that can consistently demonstrate that they are good performers, who deliver on their promises to customers, versus companies that simply put forward ambitious targets that they then fail to deliver. These criteria are particularly important where Ofwat may be using the stretching targets imposed by one company to inform targets for others. Without a strong track record of delivery these targets may just be overly ambitious suggestions that are undeliverable.

Q11.4. Do agree with our proposed reputational, financial and procedural rewards and penalties, including the overall package of reward and penalty?

No, we do not agree with the proposed rewards and penalties.

It is not appropriate to have a business plan incentive with a downside financial adjustment to the cost of equity as this conflicts with Ofwat's financeability duty. Incentives for good business plans have been used in both previous water price controls and other regulated sectors. In the water sector at PR14 and PR19 they have consistently involved only 'rewards' to the allowed equity return not penalties, which have been either procedural, reputational or driven through the underlying parameters (for example, cost sharing[7]). This is because the application of such penalties would make sure the allowed return, the calculation for which under the Capital Asset Pricing Model (CAPM) is done on a sector-wide basis, is insufficient to remunerate shareholders for the level of risk incurred. This approach would therefore be in clear conflict with Ofwat statutory duty to 'secure that water companies can (in particular through securing reasonable returns on their capital) finance the proper carrying out of their statutory function'.

[7] We note that the CMA criticised the use of cost sharing rates in the Initial Assessment of Business Plans at PR19 and applied a more symmetrical cost sharing rate to companies in their final determination.

The potential rewards and penalties are very high, given the lack of detail in the .ambition. criteria at this stage. We note that the ambition criteria focus on stretching performance, efficient costs, and well justified enhancement schemes – but if a company doesn't meet Ofwat's ambition on these, then Ofwat will already intervene in its determinations to set higher PCs and lower costs. This further incentive seems to penalise companies who weren't able to forecast Ofwat's view on costs or PCLs, rather than unambitious companies (who would already see the challenge on ambition via the determinations).

Ofwat has explained that its goal for the business plan incentives is to incentivise companies to propose business plans with stretching levels of service at efficient costs and deliver affordable wider value for customers, communities and the environment. However, it is not clear how these incentives would achieve their goal. Ofwat notes two reasons for including these:

- "They delivered good results for customers, communities, and the environment at PR19 and PR14 when we were able to use the information provided in the best plans to challenge the rest of the sector". Ofwat considered this in its lessons learned for PR19 and reflected that this would need careful consideration to the package of reputational, financial, and procedural incentives – it did not say that it would automatically use a similar approach. Ofwat's lessons learned did not make any attempt to quantify the benefits for customers in using business plan incentives, and these have not been evaluated since. It should reflect on this and make sure these really are expected to have benefits for customers (noting that some of these benefits will now already be gained for customers through Ofwat's challenge on outcomes and costs for unambitious companies). Ofwat should then be clearer about how it will use the results from ambitious plans to challenge others, and the expected benefits to customers of doing this.

- "Companies providing the best business plans can turn their attention more quickly to delivery for customers, communities and the environment". It is not clear how this would be the case at PR24, with the IAP stage and DD stage now aligned. Outstanding customers would receive protection from reductions in allowed return on capital and base cost allowances at final determination (FD), but this does not seem to provide any procedural benefit – if Ofwat now considers its plan to no longer be stretching, such that tighter efficiency challenges on base costs and WACC would now be justified, it is difficult to see why customers should be asked to give this up. Outstanding companies would still expect to proceed with their plan after DD even if they knew that there could be slighter tighter base costs and cost of capital – this should not delay them in practice.

Ofwat has not considered the long term when proposing business plan incentives. A much stronger incentive would be to provide some long-term certainty for companies who produce ambitious business plans. For example, this could include committing to enhancement expenditure in future periods. This would not need to be the full amount required, but instead a 'no regrets' allowance (based on the pathways from the long-term delivery strategy) that might be set at the lowest

plausible range that Ofwat would set at PR29 (for example, at 80% of the expected costs). Similarly, Ofwat could set stronger expectations about long-term PCs for the most ambitious companies.

Setting this commitment to long-term allowances would have a significant impact on early certainty, with those companies able to plan their supply chain and investment programmes for a longer period. This provides early certainty for supply chain companies and stakeholders, which would know that funding is available for service improvements after 2030. This would have very little risk for customers, who would likely instead benefit from this more efficient approach (noting that this is only available for ambitious companies).

Companies that lack ambition could have enhanced reporting built into the 2025-30 period to test how they are delivering the Ofwat challenge on service levels and cost efficiency. This would help Ofwat to differentiate between high performing companies, which plan to deliver stretching performance at efficient costs, and companies that do not meet the benchmarks that Ofwat expects. Ofwat has not identified any downside 'procedural' incentives for PR24 but in practice, these were applied to the 'significant scrutiny' companies at PR19 where plans were not adequately revised before FD.

We also note that business plan incentives are considerably weakened at PR24 when Ofwat has suggested that it will, in practice, set far more of company business plans centrally than at PR19 and PR14. That includes setting base costs, more enhancement costs through benchmarking, WACC, RCV run-off rates (within narrow ranges), PCs, and ODI rates. Ofwat has not considered or quantified how this will affect the benefits from business plan incentives.

Given this, large 'financial adjustment' business plan incentives aren't justified at PR24. Instead, Ofwat should consider whether early certainty about investment after 2030 is a stronger incentive which provides more benefits and less risk to customers.

Adjustments to the cost sharing rate do not create an incentive for good quality and ambitious business plans (see our response to Q6.3, which tackles this).

Q11.5. Do you have any other comments regarding our proposed approach to business plan incentives at PR24?

At PR19, Ofwat considered how business plan incentives could continue to apply after the first submission of plans. The PR24 consultation does not consider this in the same way:

- It should be possible to access rewards after the initial submission, to incentivise companies to respond to the draft determination with a more ambitious plan. Cost sharing rates (or the alternative approaches we suggest in our response to Q11.4) could be modestly improved in response to a revised plan (we strongly believe that

sharing factors should remain broadly symmetric), but it seems unreasonable to include a financial adjustment for the first time at FD (as others would not have the opportunity to challenge this).

- Commitments to early certainty on future investment, and/or enhanced reporting requirements, could be signalled at DD if the company completes their actions and sets a more ambitious plan, and then applied at FD. These are not formal parts of the revenue controls, and there would be more discretion in setting these.

- The ability to access rewards after the initial submission would reduce the risk that business plan incentives become just about using the Ofwat view which may be wrong and not adopted by any companies. This reduces the risk for Ofwat that if they set criteria that are too challenging, no company can achieve the business plan incentives and all benefits for customers are lost.

- Ofwat proposes that business plans will be submitted in October, with feedback for the first time at DD. It would be helpful if Ofwat could provide early certainty on elements of the plan during this time, allowing companies to revise elements of their plan or provide more evidence if necessary. There is little benefit to customers of Ofwat assessing a plan without a key piece of evidence (where the company might have this, but not considered it a necessary part of their limited business plan document suite). At PR19, the IAP was carried out on the initial business plan submission, but if the incentives were still available through the process, then this would not need to be so absolute. In practice, this was done even with fast-track companies at PR19. We note in our summary response that we support a two-stage process, which would support achieving this.