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SES Water
London Road
Redhill, Surrey,
RH1 1LJ
Telephone: 01737 772000
Facsimile: 01737 766807
Website: www.seswater.co.uk
Email: contactus@seswater.co.uk

Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

Dear Sirs,

Creating tomorrow, together: Consulting on our methodology for PR24

At SES Water we are proud to serve our community by supplying 160 million litres of fresh, clean drinking water to 745,000 customers every day. We continue to focus on delivering the best possible service to our customers and communities, whilst safeguarding and enhancing the environment we rely on.

As we look to the future and our PR24 business plan, we appreciate the opportunity to respond to the above consultation issued on 7 July 2022. As always, the level of detail contained within the consultation, and the associated materials issued by Ofwat, displays a level of thought and rigour which is much appreciated, and has allowed the Board and senior management of SES Water to perform a thorough review and assessment of the Draft Methodology (PR24 DM).

Overall, we were pleased to see that various key focus areas referenced in Ofwat's PR24 framework documents and associated workstreams continued to be prominent in the PR24 DM, including:

- The references throughout the document to Ofwat's four ambitions for PR24 – focusing on the long term, delivering greater environmental and social value, reflecting a clearer understanding of customer and communities and driving improvements through efficiency and innovation. It is clear that Ofwat has maintained its commitment to these ambitions throughout the PR24 DM.
- The solid grounding of the PR24 DM in the context of the long-term delivery strategies. We continue to view this as a very positive feature of this price review, and the complementary nature of the PR24 DM alongside of the LTDS will be of lasting benefit for customers in our opinion.
- The clear implementation of simplification initiatives in the DM, including limitation of common and bespoke PCs – we fully support these initiatives and the streamlining of the overall process.

However, there are several areas of the PR24 DM on which we have significant concern. We have provided detailed responses on such items in the attached appendix and replicated these items in Ofwat's required response template. The following matters are of particular note:

- With the proposed increase in variability of returns given the risk levels embedded in the PR24 DM, together with Ofwat's proposals on increased equity injections in PR24, the overall balance of risk and return provided by the PR24 DM is not appropriate or aligned to company or investor interests. Within our response, we have emphasised the significant concern that increased equity levels without aligned risks and appropriate levels of return has created. To the extent that the PR24 methodology requires additional capital, then Ofwat should be clear on how it will ensure that a reasonable return is earned on that additional capital. SES Water have contributed to and support the views identified within the recent industry analysis of the proposed approach to cost of capital in PR24, as provided separately to Ofwat's Future Ideas Lab. In this respect, the evidence underpinning the recent CMA redeterminations in the water sector was not fully considered within the PR24 DM and appears to be deviating from these rulings without further substantive evidence.

- It is currently not clear what Ofwat's expectations are on the performance and service levels that "base costs" buys, and there is a significant risk that Ofwat's expected performance from base cost is unsupportable. The "base buys" framework needs further articulation from Ofwat, preferably with more industry working group engagement. This is necessary to allow companies clarity in developing their plans and to ensure that what is put forward is ambitious but also deliverable.
- We were concerned about the approach that Ofwat took to retail cost modelling at PR19 – and so are highly concerned with the continued approach to such modelling signaled in the PR24 DM. In our response document we have articulated that a major rethink is needed within the retail cost modelling. Also, the inflationary pressures on the retail business are highly material which are disregarded in the PR24 DM.
- On wholesale modelling, we have identified key variables that need to be included in the wholesale cost models (such as Average Pumping Head). Capturing specific factors (that drive additional cost) like softening, energy requirements etc. are important to recovery of the efficiently incurred costs. We have concerns with use of forecast cost data in benchmarking, particularly if this risks an undeliverable efficiency challenge being set at PR24.
- We support the streamlining and simplification of PCs, the realignment of common PCs and having associated financial incentives. However, greater clarity is needed on the definitions and baselines for the new proposed PCs so that we have time to evaluate and incorporate that thinking into our proposals (e.g. biodiversity, operation GHG emissions, single water demand, etc).
- We are concerned that, if left unchanged, the proposals in the PR24 DM will result in over-optimistic and unrealistic assumptions of the level of improvement that base buys during the period. This, in turn, could lead to the imposition of further unrealistic PC level (PCL) improvements in some of the key common PCs without taking account of company-specifics and based on relatively weak evidence.
- The PR24 DM suggests removing deadbands on PCs, but there may be a valid reason to have deadbands on certain PCs (e.g. CRI) to avoid rewarding or penalising minor insignificant variances.
- Whilst we welcome the use of customer satisfaction metrics, we would like to register some concerns with the specific formulation of C-MeX. In particular, the current C-MeX methodology does not accurately reflect the relative level of customer service provided by a company, because customer satisfaction scores are influenced by factors other than the level of service received, including the level of affluence of the customers in the sample. To correct for this, standardized demographic samples could be used, to ensure scores for each company were on a more like-for-like basis.
- We note that the PR24 DM does not specifically address how regional investment will be recovered (i.e. investment into a water supply solution by another company in the region and which has been assessed as the most efficient option through the regional water resource planning process). We consider that this would need to be funded upfront, rather than in the future through the water trading mechanisms.
- We note that the PR24 review is being undertaken in a period of significant macro-economic uncertainty, in particular, with regard to the outlook for inflation, real price effects and interest rates. Companies are, for example, left fully exposed to real price effects on energy and other commodities in the absence of an uncertainty sharing mechanism and business are not protected by the Ofgem price cap. More clarity and industry engagement ahead of the Final Methodology is needed on how the impacts of real price effects and the greater exposure to cost increases throughout the supply chain driven by external events are going to be approached at PR24.

As you will note in the detailed response, there are several areas where we have asked for clarity from Ofwat ahead of issuance of the Final Methodology. We would welcome dialogue with Ofwat in the coming months on these areas and are happy to discuss any other questions that Ofwat may have upon reviewing this response.

As noted above, there are some areas where we are in strong agreement with Ofwat and some areas where we have concerns or caveated our general agreement with the presented proposal. In the Excel template we have flagged all answers where we have even just minor caveats as 'disagree' in case this is important to Ofwat's process. This should not be regarded as complete disagreement with the proposal, and we have elaborated in our comments.

Our Board has reviewed Ofwat's PR24 DM in detail. The Board was briefed and has provided input into SES Water's consultation response in a PR24 Board meeting on 19 July 2022. Through a process of continuous engagement, the Board has ensured that its comments were reflected, provided final challenge, and approved this response at a PR24 Board meeting on 5 September 2022.

Yours faithfully

Paul Kerr
Group Chief Financial Officer

Draft methodology responses

CHAPTER 2 REGULATING THROUGH THE PRICE REVIEW

Q2.1 Do you agree with the challenges facing the sector and the ambitions for PR24 we have identified?

We agree with the challenges facing the sector and ambitions for PR24 identified by Ofwat, although there needs to remain the cognition by Ofwat that such challenges will not be all encompassing – by the nature of the time frame being considered as part of this price review. "Black swan" events that are unpredictable – such as Covid-19 and the recent Ukrainian conflict– will result in increased risks being faced by investors and increase costs – and so the potential to underestimate such matters will always exist.

Q2.2 Do you agree that continuing to use our three building blocks helps push companies to meet our ambitions for PR24? (Please provide detailed comments on specific building blocks to the relevant chapters.)

We agree with Ofwat on the continuing use of the three building blocks – outcomes, costs and risk and return – to meet its ambitions for PR24. We have provided key comments from our perspective on all three building blocks in the respective sections of this response.

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

Overall, we agree with Ofwat's balance of items in and outside of the price controls.

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?

Assuming that this question relates to Ofwat's evaluation of the price review process and outcomes (as opposed to progress on individual companies' progress on their business plan submissions), we do not have any specific questions to be proposed at this point in time. Ultimately the evaluation of price controls will be whether the sector has been properly motivated, incentivised and supported to deliver these vital long-term ambitions for its customers, and whether the price review enabled the right set of immediate actions in AMP 8 that will be of lasting benefit to customers in the long-term.

CHAPTER 3 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? If you have a preferred approach, please provide reasons, including any thoughts on how the options we set out in Appendix 2 could be improved.

We agree with an introduction of an adapted water trading incentive. From SES Water's perspective, by retaining many of the features of the current incentive, this allows for the continuation of relatively short-term trades that do not require significant new infrastructure to support them.

Beyond this point, we do not have any further comments on the proposed approaches although we appreciate the need to take into account time-lags where new infrastructure builds are required to support both our own long-term requirements and those to support the wider regional needs where SES Water has been identified as a wider water trader.

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?

a) We agree that network reinforcement should be included in the network plus price controls.
b) We have no comments on wastewater site-specific developer services.

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 agree that inclusion of network reinforcement in cost sharing will be sufficient to manage such uncertainty.

Q3.4 For water site-specific developer services:

a) Do you agree with our proposal to exclude new developments of more than 25 properties from the wholesale water network plus price control at PR24, but with transitional arrangements for companies with low levels of competition?
b) Do you think that new developments of 25 properties and fewer should remain in the wholesale water network plus control or be removed? If they were removed from the price control, what alternative protections could we introduce to protect new connection customers from monopoly power?

a & b) For clarity and complete transparency, we would like to see all developer services activity in a separate price control, however recognise that given the complexity and nature of the industry, careful consideration of how activities and costs would be segregated into separate price controls in smaller companies where shared resources are used.

Q3.5 Do you agree with our proposals:
a) To raise the size threshold above which companies should deliver schemes through DPC to around £200m lifetime totex?
b) For companies to deliver schemes through DPC by default above this threshold?

a & b) Given the size of these DPC schemes, these are not applicable to SES Water, so we provide no comment.

Q3.6 Do you have any views on any other aspect of our proposals in relation to:
a) The design of price controls;
b) Water resources;
c) Developer services;
d) Retail activities;
e) Bioresources;
f) Other controls;
g) The revenue forecasting incentive mechanism; or
h) Direct procurement for customers?

We have no further comment on a) The design of price controls, c) Developer Services, f) Other controls or g) The revenue forecasting incentive mechanism. The proposals on e) Bioresources and h) Direct procurement for customers are not applicable for SES Water. However, with respect to the remaining proposals:

b) Water resources
We appreciate the effort to encourage competition by making water resources as a separate control in wholesale water. However, much of the cost efficiency and outcome performance in this segment of water supply is dependent on environmental factors, such as the local geological strata that may hold suitable aquifers, the extent to which local topography facilitates the creation of impounding reservoirs, and local levels of rainfall. Using company submitted data to assess cost and performance at PR19 did not result in any meaningful prediction in the past. We therefore recommend that for PR24 external data from independent sources is utilised to assess water resources efficiency. Alternatively, engineering deep dive assessments can be used in addition to econometric cost modelling. Furthermore, we would encourage the independent evaluation to be staged carefully over time and assessed independently by a further third party.

d) Retail
In terms of the overall residential retail price control, we do not object to setting an average revenue control based on the number of customers companies need to serve. However, as noted elsewhere in this consultation response, we remain significantly concerned with the approach to modelling retail costs and the associated retail cost benchmarking. In particular:

- The retail cost assessment approach requires a fundamental change in modelling methodology and cost drivers, and requires a "bottom-up" cost analysis to ensure an understanding of the true drivers of relative levels of efficiency and service quality. For example, total connected household properties are not a sound basis to explain retail unit cost. While population characteristics such as deprivation and transience can partially explain debt related cost only, non-debt cost such as customer service, meter reading, payrolls, general supporting cost (shared with wholesale) and minimum fixed cost (e.g. software licence, size threshold that makes outsourcing more cost saving) account for more than half of total retail opex (based on industry APR 2022) and therefore need their own meaningful cost drivers.
- In addition, for the retail cost assessment to be meaningful, consistency of cost allocations between wholesale and retail across all companies is essential. As noted above, there is still a case for improved cost drivers even just for the allocation to become more consistent - for example where FTE are used to allocate costs, companies which outsource part of their retail operations might end up looking more efficient, where this is not necessarily the case.
- With respect to benchmarking of retail costs, we support the benchmarking based on a wider set of comparators that include NAVs and other utilities, especially electricity and gas suppliers. This would provide more insight to the similarities and differences in various retail activities that explain the determinants of efficiency and service quality. It is essential that economies of scale are considered, or alternatively consideration of the fixed cost base versus variable costs.
- Finally, we strongly object to the draft methodology proposal of no automatic indexation of allowed revenues with respect to the residential retail price control. There are several underlying

cost drivers within the retail price control that are associated with retail costs, including FTE costs, and therefore not allowing indexation of such revenue is not logical or appropriate, particularly in the current macro-economic environment.

CHAPTER 4 REFLECTING AN UNDERSTANDING OF CUSTOMERS AND COMMUNITIES

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 broadly agree with Ofwat's approach to ensure that companies' price review submissions reflect of the views of the customers and communities that we serve, including environmental concerns. However, we remain concerned regarding the timing of receipt of customer views via the collaborative research being conducted with Ofwat and CCW, being conscious of the delays in this process to date. If customer views are obtained too late in the process, associated customer preferences may not be fully reflected in our proposed performance commitment levels and associated outcome delivery incentives.

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

We believe open challenge sessions which are held prior to business plan submission could be an effective supplementary form of customer engagement but the guidance provided to date does not give us sufficient clarity on several aspects of this proposal to have confidence that this will be the case. If they are included in the final methodology, it is essential that they meet the same standards set for the customer engagement programme as a whole and that adequate time and thought can be given to finalising the details of how they are to be run and to organise them accordingly. Areas where we would welcome further clarity include:

- how the feedback received at such sessions would be weighed against insight gathered through other engagement mechanisms while developing our business plan submissions. It will provide only one additional data point and triangulation will remain of the utmost importance.
- what mechanisms are proposed to ensure that the attendance at these sessions is balanced and inclusive and that this element of the engagement meets the standards laid out by Ofwat for the overall programme, including who will be assuring this; and
- confirmation of whether CCW/Ofwat are going to prescribe the nature or content of the company presentation during those sessions.

We also believe that a challenge session post business plan submission could play an important part of our ongoing customer engagement process which needs to extend before and beyond the price determination process itself. Within the price determination process itself however, it is important that everything relevant can be taken into account. A challenge session post business plan submission does not seem to give companies the opportunity to respond. Additionally, as noted above, this is only one further data point, so would again, need to be triangulated and any responses previously given by the company regarding the same points would need to be considered by Ofwat.

Q4.3 Do you have views on open challenge sessions can align with the collaborative approach in Wales?

Without further details, we have no comment on alignment with the collaborative approach in Wales.

Q4.4 Do you have views on how the outcome of collaborative customer research can contribute in the context of the collaborative approach in Wales?

No comment aside that the process should be consistent with that adopted in England.

CHAPTER 5 DELIVERING OUTCOMES FOR CUSTOMERS

Q5.1 Do you agree with our proposed package of common performance commitments? Is water demand best incentivised through separate performance commitments on household and domestic consumption and leakage or through a performance commitment measuring total demand?

We support Ofwat's proposals to simplify and streamline the number of performance commitments, and the concept of a set of common (financial) PCs between all companies is sensible and allows comparison between them. The three broad categories and individual PCs within them seem broadly aligned with and proportionate to the key PR24 themes, in particular thinking about the long term and environmental / net zero concerns. On the latter, the introduction of new common environmental PCs (e.g., on biodiversity and single water demand) should be carefully designed to ensure they are data-driven, measurable and proportionate (see response to question A6.5 for more details on biodiversity).

We also support Ofwat's intention to use tools outside of the price review to incentivise performance in areas that are not included within the outcomes package at PR24. We note that Ofwat has stated that it considers that a performance commitment does not need to be fully in a company's control for it to be worth incentivising. However, we consider that where a performance commitment is subject to external factors, the performance commitment should be calibrated in such a way that it reflects this risk.

We appreciate that it would be simpler to measure water demand related performance commitments through separate performance commitments for household and non-household consumption and leakage. However, we see the advantage of combining these PCs to incentivise companies to apply technical solutions that can address all water demand related performance at the same time, e.g., through smart metering and smart leak detection. As companies are required to report consumption and leakage reduction separately anyway, a total demand performance commitment still can be used as additional measure or a composite performance. We support the introduction of a total demand performance commitment in PR24, with the separate report for household and non-household consumption and leakage remaining in place. Actual performance at the end of PR24 would allow us to compare between the traditional separate assessment and the combined performance for further improvement of assessment.

Customers reflect on the benefit of combining water usage and leakage as it helps them to save water and reduce wastage and helps them to better understand the relative importance and significance of both ways of reducing demand.

Whilst in principle we support a new combined measure in additional to the existing measures, we feel strongly that any ODIs associated with these PCs should be on either the separate or combined measure only and not on both.

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

We welcome Ofwat's proposed guidance and the clarity on the number of bespoke performance commitments it expects each company to put forward.

We also welcome Ofwat's proposal that companies provide an early submission for bespoke performance commitments in Spring 2023, which for SES will include continuation in some form of our bespoke water softening PC. In the recent drought conditions, SES Water made the decision to temporarily stop softening in order to maintain its water supply to our customers. This was the right thing for our customers even though through the current ODI design we are incentivised not to stop softening under any circumstances. We will adjust the definition our bespoke softening performance commitment at PR24 to always incentivise the right behaviour for our customers, in line with the objectives of the regulatory regime.

Timely feedback from Ofwat on the draft bespoke performance commitment definitions will be particularly helpful ahead of our business plan submissions to Ofwat in autumn 2023.

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

We agree in principle with Ofwat that simplifying the formula, making rates symmetric and focusing on marginal benefit are moves in the right direction towards making rate-setting simpler and more theoretically robust. However, in the absence of the outputs of the collaborative research (turned into marginal benefit estimates) and Ofwat's decision on the sharing rate, it is difficult to assess the real incentive and financial impacts on actual companies of the proposed approach compared to PR19. In addition, given the potential difficulties in eliciting customer views and measuring marginal benefit for certain performance commitments (including for asset health PCs), we would welcome further guidance in the final methodology on when and how the potential alternative approaches (including top-down) would be applied.

We would appreciate more clarity on how ODI rates are going to be calibrated, particularly in the context of the potential removal of deadbands, to ensure that actual companies are not disproportionately penalised (or rewarded) for relatively minor fluctuations in performance that do not (or only minimally) impact customers' experience and where otherwise inefficient investment would be incentivised to reduce the downside risk to the actual company from ODIs to an acceptable level. We would also appreciate further insights into how exactly the final benefit sharing rates will be calculated and set (appreciating the need for flexibility and cross-checks proposed here) to ensure that ODI rates are reasonable given base cost allowances, cost drivers and cost-sharing rates.

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 do not support increasing the size of the overall rewards and penalties available under C-MeX. In principle, we consider that the ODIs for the other key customer-facing common performance commitments already broadly reflect customer valuations of good and bad performance on key metrics driving customers' experience of the company, and that there is, therefore, a degree of double counting with the experience survey aspects of C-MeX (and hence over-valuation of impacts and incentives at the aggregate level across C-MeX and other PCs). This problem would be exacerbated by increasing the size of incentives under C-MeX. If Ofwat is concerned that PR19 ODIs potentially undervalue customer impacts on key metrics, its proposed improved methods for setting ODI rates at PR24 (which we support in principle), together with the collaborative customer research it has designed, should address this concern by further improving the calibration of ODI rates on key customer-facing metrics. We also note that in the work done in preparation for the collaborative research, Ofwat's own engagement shows that customers rate customer satisfaction as less important than other key outcomes which supports the focus on getting the ODI rates right for those other key metrics.

We note that the current C-MeX methodology does not accurately reflect the relative level of customer service provided by a company, because customer satisfaction scores are influenced by factors other than the level of service received, including the level of affluence of the customers in the sample. To correct for this, standardised demographic samples could be used, to ensure scores for each company were on a more like-for-like basis.

We also note that, on the downside, C-MeX underperformance payments can already have the effect of wiping out a company's full retail margin. We consider that this is already an unfair potential penalty when the absolute level of customer service and customer experience revealed by C-MeX may be at a high level or on an improving trajectory. Increasing the downside size of C-MeX would potentially force poor relative performers to run a loss-making household retail business despite this.

Ofwat should explore linking the size of any reward or penalty to the extent of the deviation in score from the median rather than the ranking. This would have the effect of more heavily rewarding or punishing outlier performance rather than relatively high or low performance around a narrow band. We also suggest the introduction of a symmetrical zone around the median score that would attract neither outperformance or underperformance payments. This is because there is bunching of scores around the median and different absolute levels are not necessarily indicative of significantly different customer experience between companies (particularly given concerns around survey data quality, sample size, one-off timing impacts on scores, and resulting statistical significance of the survey results).

Similar considerations should apply to the design of incentives for D-MeX and any new measures such as BR-MeX.

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

We agree with Ofwat's broad approach and think centralising the research for common PCs is a sensible way to ensure consistency and value for money in estimating marginal benefit. We question if there will be any process for cross-checking the calculated results with other sources of evidence (including, perhaps, companies' estimates from PR19). This could be especially relevant in the cases where the approach is more complex, i.e., asset health-related and some of the environmental PCs. Finally, while we agree with the proposal to allow variation in ODI rates between companies unless they cause disproportionate complexity or create perverse incentives, we think it would be useful to have further guidance on what exactly constitutes these exceptions and if there is any limit as to how much the rates can vary.

Q5.6 Do you agree with our proposed approach to incentivising asset health performance?

We appreciate that setting incentive rates for asset health is challenging. We are concerned that if incentives are based on inferred benefit only, without regards to cost of failure, they may not capture the full value of two-sided incentives. As to the methodology for setting incentives rates for this performance, we are not clear how it would drive companies' effort or investment in meeting asset health expectations.

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

We support the concept of enhanced ODIs that was introduced for the first time at PR19 and welcome Ofwat's proposal to continue with enhanced incentives at PR24. We agree that the PR19 enhanced ODI scheme was over-complex and the methodologies for setting enhanced thresholds and ODI rates were difficult for companies and stakeholders to assess and understand and welcome Ofwat's proposal to streamline the scheme. We are supportive of Ofwat's proposal to make enhanced ODIs available to all companies on selected performance commitments, rather than being company-led.

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

We support the proposed approach in principle. However, performance commitments eligible for enhanced incentives will need to be chosen with care.

For example, where there are inconsistencies in measurement and reporting of a performance commitment by companies across the industry, this could lead to perverse incentives for those companies with this enhanced incentive. As such, we would expect any enhanced incentives to have a well-established methodology for calculating and reporting performance across the industry.

We also note that leakage may be part of a wider 'total demand' performance commitment that would also include PCC and business demand. Should leakage be part of a 'total demand' performance commitment, we do not think the resulting performance commitment would be a suitable candidate for enhanced incentive as it would not comply with Ofwat's 'well-established' criterion.

We expect Ofwat to specify which common performance commitments will be subject to enhanced incentives in the final methodology.

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

We welcome Ofwat's proposal that enhanced ODIs are outperformance only as we see this as really incentivising innovation while reducing the risk exposure associated with the enhanced underperformance incentive.

For enhanced incentives to be meaningful at PR24 a clear methodology is needed which will result in thresholds that are consistent and are not so far out of reach (even for high performing companies) that they failed to incentivise innovation, and which have reward levels which are meaningful and will potentially compensate for the costs of innovation. We note that, at PR19, SES Water was subject to two enhanced incentives (water supply interruptions and leakage); however, the thresholds set for these enhanced performance commitments are extremely unlikely to be achievable within the AMP and therefore fail to incentivise the innovation that was hoped for.

The proposed theoretical approach to setting enhanced thresholds and rates appears reasonable, however, we note Ofwat's intention of using historical and forecast performance to set the thresholds for each performance commitments beyond the current frontier. We would welcome further clarity on the methodology for setting those enhanced thresholds in the final methodology as the end-result will be sensitive to the inputs used.

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

SES welcome knowledge sharing in principle, and in fact already do share as a matter of course to support other customers, companies and stakeholders. An example of this is our extensive sharing of our thought-leading intelligent leakage knowledge. We would welcome further guidance on what good looks like in terms of 'timely, open, and transparent' engagement, as well as a better understanding of the 'clawback mechanism' proposed.

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 agree in principle with Ofwat's proposal to apply caps and collars on a more targeted basis and that they should therefore apply to a smaller proportion of PCs. However, we are concerned that the existence of "natural" caps or collars on certain PCs may lead to unintended asymmetrical ODI risks to the up- or down-side if they are not balanced by countervailing caps or collars. This should be considered in finalising the list of PCs eligible for caps or collars, in addition to the principles articulated by Ofwat.

In addition, we consider that there should be continued use of a collar for underperformance in CRI (as well as a deadband, see our response to Q5.12 below) as the index can vary significantly in response to single failures, depending on the parameter and population potentially affected, as evidenced by variations in industry performance since the index was introduced.

We support Ofwat's proposal to make caps and collars more symmetrical at PR24. We note Ofwat's starting position that, where there are caps and collars, these could be set at ±0.5% RORE for individual PCs (or +0.25/-0.5% for asset health PCs and other PCs with "clear diminishing marginal benefits" to outperformance). We consider that the appropriate level of any caps and collars may vary by PC and will depend on a combination of the likely range of outcomes of performance on the up- and down-side, the marginal costs and benefits of performance, and the ODI rates set by Ofwat. Therefore, there should not be an automatic presumption that all caps and collars will be set at the same levels even though it is simpler to do so.

We support the introduction of a two-sided aggregate sharing mechanism in principle. We note that the financial risk borne by investors depends on the shape of the probability distribution of the rewards and penalties, as well as the boundaries of the range. Regarding the proposed ±3% RORE for the primary sharing threshold, we would like to see more supporting evidence that it is based on the likelihood and average outcome for all companies. For the secondary sharing threshold at ±5%, if historically no company has ever reached that threshold, the threshold would be meaningless and unlikely to be triggered. Both primary and secondary sharing thresholds should be based on the mean and the variance of historical performance and the shape of the probability distribution of outcomes across the PC portfolio. This also implies that it may not be appropriate for the sharing mechanism to be fully symmetrical on the up- and down-sides.

We note Ofwat's comment that aggregate sharing thresholds may vary by company, where there are material concerns with the overall level or skew of risk faced by a company, and that adjustments to the risk-sharing thresholds will be considered before other targeted interventions. We consider that this approach may be a blunt instrument to deal with very narrow issues on specific PCs. Any adjustment should therefore be based on analytical evidence about the level or skew of risk for a company and an assessment of whether a targeted intervention is more or less effective than a general adjustment to the aggregate risk-sharing mechanism.

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

We agree with Ofwat that companies should typically face financial upside and downside incentives for any deviation from the performance commitment level, where that performance is within the company's control. To the extent that performance is outside company control, then deadbands should be used to prevent windfall gains or losses from random external factors. The removal of deadbands and resulting increased variability of returns would need to be taken into account when calculating the appropriate WACC.

The CMA introduced a number of company- and PC-specific deadbands in the PR19 Appeals where it considered that these would be an appropriate risk mitigation measure in specific circumstances. We therefore consider that Ofwat should apply a consistent approach across the industry and not rule out the use of deadbands completely, for example (a) for new common PCs being introduced at PR24 where there is not a significant historical track record of performance and/or performance measurement and reporting is not fully consistent across the industry and/or performance is not wholly within companies' control (e.g. on biodiversity), and (b) where there are company-specific circumstances on a particular PC which makes the setting of a deadband a reasonable risk management tool.

We also consider that there should be continued use of a deadband for CRI and the introduction of a deadband for customer contacts about water quality as performance is not wholly within the company's control, especially considering the impact of customer tap and supply pipe quality on performance (for parameters such as lead and nickel) and the subjectiveness that lies with the customer on perceptions of many cases of taste, odour or discolouration. Whilst it is accepted that we are aiming for 100% compliance, or zero CRI, in reality that is very rarely going to be achieved. This is evidenced by reported water company performance.

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

We believe that a simple approach (option 1) would be proportionate if the results are being used simply for presenting the estimated revenue risk from ODIs to stakeholders and investors. The publication of such estimates would need to be accompanied by appropriate explanations for stakeholders including caveats. We are still concerned about the lack of detail of how this option would be implemented, e.g., how "probable performance primarily based on historical performance and companies'" would be used to derive forecast performance levels. And what does Ofwat mean in practice when it says it will "take a proportionate approach to aggregating risks"? For example, if it proposes to use a set of scaling factors, we suggest consulting on these with the companies in advance.

However, something more akin to Ofwat's/PwC's option 2 would be required if the estimates are going to be used for assessment of individual or overall ODI skew as this would feed into decisions about calibration of e.g., caps and collars on individual PCs, the thresholds for the aggregate sharing mechanism, or other targeted PC/ODI interventions. We consider that this would require an in-depth assessment of likely distributions of individual performance outcomes and aggregate outcomes, reflecting interdependencies and correlations across PCs. We note that Ofwat is not proposing at this stage to use bottom up historic/forecast performance distributions to develop caps and collars - and we would need more detail about how estimates might feed into the setting of aggregate risk sharing or other ODI interventions, especially as we understand that interventions could be made at the company or PC level to correct for skew (see our response to Q5.11). In conclusion, we believe that the overall approach to ODI risk mitigation/risk sharing needs to be considered in determining the appropriate methodology for estimating ODI risk and the information that is required from companies in this area.

Company views on the historic and forecast range of performance outcomes and hence level of skew (if any) associated with PCLs and ODIs would be useful input into the business plan review and determination process.

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.

We agree with Ofwat that providing greater clarity over its intended approach to outcomes in PR29 would be in the interests of customers.

Providing greater certainty over incentive rates at this stage is likely to reduce flexibility to reflect changes in customer preferences over time. Recent events such as the Covid-19 pandemic, the cost-of-living crisis, and Russia's invasion of Ukraine are three examples of extraordinary unforeseen events that have affected the water industry and customers in unexpected ways. The Covid-19 pandemic has had significant impact on consumer behaviour (e.g., PCC, business demand, retail bad debt) and the ongoing cost of living crisis is expected to keep affecting consumer behaviour. The pandemic also started a general supply chain disruption in November 2020 which was made worse by Russia's invasion of Ukraine especially - but not exclusively - regarding energy and chemicals costs.

In this context, giving greater certainty over specific incentive rates in PR29 would not appear appropriate.

We agree with Ofwat that the water sector needs to have a clear longer term delivery strategy to deliver performance improvements over multiple price reviews and for that to be funded. Clarity over Ofwat's intended overall approach to outcomes in PR29 would therefore be welcomed in this context, including how such an approach could interact with multi-period PCs or PCDs where there are multi-period enhancement activities or investments. Similarly, it may be possible for Ofwat and the industry to agree the tramlines of capital maintenance or asset health/ resilience expenditure over multiple periods (as in Scotland), in which case it may be appropriate to balance that with tramlines of associated performance levels for PR29 and potentially beyond.

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

We agree with Ofwat's proposal to retain the ODI payments annually (in-period) and option for companies to request to defer the impact of ODI payments between years. The ±1% RoRE threshold appears reasonable.

Q5.16 Do you have any wider comments about the ODI framework at PR24?

We have no further comment on the ODI framework at PR24 at this stage.

CHAPTER 6 SETTING EXPENDITURE ALLOWANCES

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

From an overall perspective, we are supportive of the overall structure of the proposed PR24 cost assessment framework in the consultation, which builds on the approach taken by Ofwat in PR19. In particular, we welcome:

- The evolution (not revolution) of the wholesale base cost modelling
- The clear and transparent proposed approach to enhancement expenditure
- The proposed use of further external benchmark to assess water sector efficiency
- The continued ability for companies to submit cost adjustment claims where the cost assessment and benchmarking models do not fit individual company circumstances

However, there are elements of the proposed cost assessment framework that require a fundamental revision from PR19, plus other areas that require further consideration by Ofwat prior to the Final Determination as follows:

- **Retail cost modelling:** We firmly believe that the retail cost modelling had fundamental flaws at PR19 and ultimately is inconsistent with Ofwat's own benchmarking principles as set out in the Draft PR24 Methodology. It is not appropriate for Ofwat to simply build on PR19 retail costs models for PR24, as is signalled in the Draft Methodology without properly considering potential improvements. A fundamental review of the approach and specification for retail cost modelling is needed, including closer investigation of the reasons for the differences in companies' costs that may be due to external local factors that have not been previously/adequately accounted for in Ofwat's assessment.
- **Wholesale cost modelling:** We support the evolution of the wholesale base cost modelling from PR19, but as we have represented in a series of Cost Assessment Working Group meetings, consider that Ofwat should wherever possible look to adopt changes in the explanatory variables that it uses directly in its econometric models, reducing reliance on cost adjustment claims. For example, we support the use of average pumping head as an explanatory variable in the base cost models to directly capture how differences in network typology and density may impact company costs. We consider that further information is needed of how Ofwat intends to approach the issue of 'what base buys' in its cost assessment.

We expand on these points below.

Retail cost modelling

As at PR19, we strongly consider the retail cost modelling to be fundamentally flawed and not fit for purpose. The proposal to simply build on the PR19 retail cost models for PR24 is not appropriate and Ofwat should revert to first principles as the various retail cost models appear fundamentally inconsistent with Ofwat's benchmarking principles.

Specific comments that we would highlight on the retail cost modelling are as follows:

- Key variables in PR19 retail cost models violate the principles of cost assessment Ofwat stated in its methodology – consistent with operational, and economic rationale, and outside companies' control. We strongly encourage Ofwat to look far beyond the PR19 models for retail, to analyse the retail business operation characteristics thoroughly, in order to develop models that make sense, instead of mining for variables that make the model look good and pass diagnostic tests, but which do not reflect reality.

- We welcome the effort to further search for a sound debt cost driver to improve that part of retail cost assessment.
- We are concerned about the non-debt cost assessment approach. Non-debt cost accounts for more than half total retail operating cost, and yet the PR19 style models did not offer any meaningful cost driver for this part of the service.
- Average bill is a highly endogenous variable. It is calculated as the total revenue (which is determined by allowed cost through the financial model) divided by number of customers. While the number of customers or connected properties are exogenous variables, their effect on unit cost is non-linear. Using average bill, in combination with the numerator and denominator being problematic in explaining cost, the models cannot be interpreted intuitively. Consequently, the average bill variable causes a reverse causality that wipes out any explanatory value of the supposedly explanatory variable. The only merit we can see with the use of this variable is that it increases the model's R-squared, due to its endogeneity and hence high correlation with cost.
- Proportion of metered household is another problematic cost driver. As pointed out by the CMA, metering helps saving water and cost, and it is company's choice. This variable is both endogenous and poorly justified.

In addition, we consider there are two important elements of the Draft Methodology and retail cost modelling framework applied at PR19 that require reconsideration:

- Many retail costs are directly proportional to the revenue that needs to be billed and will inevitably increase with inflation. As we are facing an uncertain inflation outlook, with double digit inflation forecast, it not sustainable to omit inflation indexation from the retail price controls.
- Ofwat's choice of benchmark for the retail cost modelling also requires reconsideration from PR19 – the approach that was adopted at PR19 led to volatile and widely varying results, and so there needs to be justified evidence in the Final Methodology statement for how Ofwat proposes to ensure it selects an appropriate benchmark at PR24.

<u>Cost claim: implicit allowance, symmetrical adjustment and role of in model explanatory variables</u>

As noted above, our view as expressed in recent cost assessment working group meetings is that wherever possible, Ofwat should rely on model explanatory variables as a 'first best' solution to capture the drivers of relative company cost performance across the sector.

For example, Average Pumping Head needs to be included as an explanatory variable in it's the wholesale base cost models at PR24 as an indication of the economic and operational challenges that companies face (e.g. topography and network density) to pump water into, within, across and throughout the wholesale network and to capture the impacts this may have on the relative operating costs in the sector (e.g., relative power costs). While the cost adjustment claim process provides an alternative means to capture factors that may drive differences in costs across the sector, we consider this to be a second-best solution. Ofwat also proposes to make this process more challenging at PR24 via a symmetrical cost adjustment claim process. As a result, we would encourage Ofwat wherever possible to seek to capture important cost drivers, such as average pumping head, within the base models directly.

As regards the symmetrical cost claim adjustment process Ofwat has proposed for PR24, while this may sound like a rational regulatory measure for claims to be applied consistently across the sector, we consider there are several drawbacks to the proposed process that warrant consideration in advance of the methodology being finalised:

- It will add more uncertainty to companies' business planning. Successful claims from one company could reduce cost allowances from another one that may have completely different operational characteristics that are not adequately addressed in the original company's cost claim.

- There is a significant risk that without clear guidance and principles from Ofwat, that the industry could dedicate significant time and resources to having to challenge potentially poorly justified symmetrical claims that have negative effects on an individual company.
- We consider a more symmetrical claim process requires a set of clearer set of requirements of what is a sufficiently well evidenced/standard for symmetrical claims, given the impacts that individual company's submissions could now have on other companies in the sector.

Unless a thorough literature review and a sound and consistent methodology can be presented by Ofwat, we do not recommend this measure as part of the cost assessment.

Network reinforcement

- We support treating this cost as part of base cost for econometric modelling. Separate assessment is prone to 1) cost allocation among network and the rest of base cost; 2) data definition inconsistency between distant historical period and more recent one; 3) finding and justifying cost drivers that satisfy all the principles can be a challenge.

Growth cost

- We support the treatment of general growth cost as part of a base model.

Use of forecast data

We support the use of forecast data as a cross check against actual historical data. We fully understand that forward looking modelling should be considered as an improvement compared to PR19 approach, because we are facing a changing environment and the past cannot fully predict future development. However, there are some downsides of using forecast data. For example, forecast modelling makes the result more volatile. If a company were to put in a very aggressive plan it is likely to create some complications due to benchmarking and will have interactions with the 'what base buys' question. Consequently, we think it would be useful to clearly articulate the role there is for historic and forecast data. We also suggest the following considerations while using forecast data:

- Deviation between forecast (business plan) data in PR19 and actual data that help evaluate the reliability of forecast.
- Variations of this deviation across companies that further analyse and evaluate the usefulness of forecast data.
- A reasonable weighting mechanism between actual and forecast data, between distant and recent historical data, and between types of data to be used in modelling to make sure the model balances out any excessive deviations or variations.

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

We believe that third party cost and revenue should be assessed separately and not as part of the overall base cost modelling, unmodelled base cost, enhancement cost assessment, or cost claims.

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 agree in principle with the approach. We would like to see more details of incentives for stretching business plan beyond cost sharing rates. The final methodology will need to be clear about how the incentives will be implemented, how retained cost would be treated, any pass-on to allowed revenue or RCV and so forth.

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?

We agree with Ofwat that resilience enhancement should be used to fund risks to specific and hazards. Data-driven assessments are required, which may be challenging as most hazards cannot be categorised and benchmarked across the industry for cost assessment. We suggest using a wider economy risk data to explore potential risk categories that can be common and subject to benchmarking, and those that are company or region specific.

This reflects broader concerns that the guidance provided for investment plans in this area requires very specific and detailed estimates and analysis, even within the context of a broader risk framework. While this is understandable from a value for money perspective, we think that being over-prescriptive in this area risks losing sight of the fact that investments in this area will be based on unusual and/or unpredictable events whose impacts will be by definition difficult to estimate.

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

In the consultation, Ofwat has provided a set of principles for setting PCLs and its expectations for improved performance from base expenditure and acknowledgement of adjustment of PCLs for enhancement expenditure, but this is not sufficient detail for us to agree with the proposed "approach" to setting PCLs at PR24.

We have provided our views on such principles below, and we have some key concerns in this area, namely:

- A common understanding between Ofwat and companies of "what base expenditure buys" is needed, as this underpins PCLs and the principles documented by Ofwat. It is challenging to determine performance improvements from base expenditure – as currently industry has very little data to use to do this, though we acknowledge that Ofwat faces the same challenge. One way of approaching this would be for Ofwat to engage with industry early in the process so that companies adopt a similar approach in their business plans.
- The expectation that efficient companies will continue to improve performance over the long term from base expenditure is a significant assumption and further guidance needs to be provided by Ofwat on how this will be factored into setting PCLs. We re-iterate a point made by other companies on the base cost consultation that there will be diminishing returns and increased marginal costs as performance improves.

In terms of the other principles:

- Our views on principle 1 are captured in Q6.6 below.
- We agree with the concepts captured under principle 3 for setting stretch targets and maintaining the incentive for companies to outperform over the long-term.
- With regards to principle 4, we agree that PCLs should account for enhancement expenditure, but the draft methodology is not explicit about how this will be done. Interaction of PCLs and enhancement expenditure allowances appears complex for PR24 and beyond. For PR24, the challenge is that some companies may be performing at higher PCLs today for a given base cost levels but for other companies this may be because they had enhancement expenditure in the past which others may not have had. As base expenditure and PCLs are assessed at industry level, companies would need to know which companies had enhancement expenditure in the past which would justify a given PCL. This would be a challenging exercise for all companies, but particularly smaller ones like SES Water. In terms of the long-term (LTDS) it is also

challenging to forecast future PCLs beyond 2030 where new techniques/technologies might be available, changing the way we do things (and hence the expenditure associated with this). There would be significant implications of setting the wrong PCLs for a given base expenditure. For example, if a PCL is set at a level that is too stretching to achieve with base expenditure and no enhancement expenditure was requested or allowed, a company would be exposed to a financial downside risk and incur ODI penalties for underperformance throughout PR24.

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

We broadly agree – the proposed split in Table 4.1 in Appendix 9 appears reasonable, but please refer to the challenges associated with certain PCs in response to questions 5.1 and 5.6. We think one of the main challenges will be ensuring consistency in calculations and reporting across the industry, especially for Water Supply Interruptions.

We also agree with Ofwat's rationale and proposal to set a common PCL for unplanned outage but a company-specific PCL for mains repairs (as it interacts with leakage to some extent, which would be subject to a company-specific PCL).

It is too early to propose a PCL for the single water demand, as it has yet to be agreed or even defined. However, PCLs for two of its proposed constituent parts, PCC and leakage, are possible given that these PCs existed in PR19, but not business demand, as this is a new proposed PC. Setting a PCL for the new proposed biodiversity PC faces similar difficulties, although SES Water has a bespoke performance commitment on this at PR19. (See 5.1, A6.5)

We agree with setting separate common levels of performance in water and wastewater from base expenditure for operational GHG emissions (see A6.6)

We agree with the "Full compliance" PCs.

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?

For the reduction of greenhouse gas emissions, we generally agree with the principle of setting a common reduction level for operational emissions, allowing efficient expenditure to meet this target and then competitive bidding for additional funds where companies have promised to go beyond that target. However, this clearly depends on the level of common reduction targets agreed and whether such targets are truly achievable through the base and enhancement expenditure allowed. In addition, for a smaller company like SES Water, any type of "bidding for funding" is inevitably difficult given the limited resources available for us to dedicate to this work (when the outcome is uncertain) compared to the larger WASCs.

Being a water only company we have no comment on reducing the use of storm overflows.

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

No comment.

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

We agree in principle. However, the overall assessment approach for both cost and performance level should be balanced between the minimum performance to be funded through base cost and the more challenging level of performance to be funded through enhancement allowances. Operating environment characteristics play an important role in affecting both performance and cost. The distinction between factors within companies' control and external factors should be made as clear as possible.

We are concerned that setting the minimum time horizon of 30 years may discourage companies from investing in schemes that bring more upfront benefits and address urgent needs.

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 with Ofwat on the proposed changes to facilitate greater use of nature-based solutions.

CHAPTER 7 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?

With the proposed increase in variability of returns given the risk levels embedded in the DM, together with Ofwat's proposals on increased equity injections in PR24, the overall balance of risk and return provided by the DM is not appropriate or aligned to company or investor interests. Within the response, we have emphasised the significant concern that increased equity levels without aligned risks and appropriate levels of return has created. To the extent that the PR24 methodology requires additional capital, then Ofwat should be clear on how it will ensure that a reasonable return is earned on that additional capital. The removal of deadbands increases revenue volatility for any given RoRE range to the extent that a higher WACC may be needed.

Q7.2 Do you agree with our proposals on the regulatory regime for managing companies' exposure to uncertainty over 2025-2030?

We agree with the proposal for managing exposure to uncertainty in AMP 8 through the reconciliation mechanisms set out in Appendix 13 of this consultation. However, we welcome Ofwat's proposal to simplify the number of reconciliations further and not encourage further uncertainty or incentive mechanisms to be introduced.

Q7.3 Is there value in introducing more prescriptive requirements and guidance for company produced RoRE risk ranges? How might this be implemented for:

a. Interactions between performance on cost and service?
b. Interactions between performance on different ODIs?

We do not consider there to be any further value in prescribing further guidance on company-produced RoRE risk range – if companies are required to provide clear explanation of their choices.

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

SES does not support Ofwat's proposals on the Risk-Free Rate (RFR). Ofwat should give greater weight to the conclusions of the CMA PR19 redetermination on RFR in its Final Methodology and the consultancy Oxera's proposed RFR estimates (as commissioned by a group of water companies and submitted to Ofwat's Future Ideas Lab).

The Oxera report for the water companies proposes a practical approach to address there being the existence of a convenience yield in the returns of gilts. SES supports this approach, which is consistent with the CMA's methodology for the PR19 redetermination, where the RFR is estimated as an average between the yield on AAA corporate bonds and the yield on gilts.

The Oxera proposal addresses the issue that:

- gilt yields are likely to provide an underestimation of the true RFR; and
- yields on AAA bonds are likely to provide an overestimation of the true RFR.

SES consider Oxera's proposal a practical and simple way of estimating the RFR at PR24 and which will address the risk the RFR is underestimated in Ofwat's current proposals. SES also support Oxera's conclusions that there are several arguments against Ofwat using SONI swap rates as a cross-check to the real RFR.

There are a number of uncertainties associated with the estimation of the RPI/CPI wedge at PR24.

SES supports the Oxera report findings that Ofwat's preferred 'official forecast' approach is unlikely to provide a robust estimate of the true RPI/CPI wedge. At a minimum, other approaches to estimating the RPI/CPI wedge need to be investigated by Ofwat (as part of its Final Methodology) and subsequent decisions on cost of capital for the PR24 review, particularly with the current uncertain outlook for inflation and a number of challenges of relying on official forecasts and official policy statements of inflation expectations and estimates of the RPI/CPI wedge (refer to First Economics report submitted to Ofwat's Future Ideas Lab).

Overall, SES recommend to Ofwat that it carefully considers the methodology that is set out by Oxera in its report and change its Final Methodology to be more aligned with Oxera's and the CMA's PR19 redetermination findings.

The First Economics report (again submitted to Ofwat's Future Ideas Lab) further demonstrates that there are a number of challenges with the proposals that Ofwat has outlined in its in Draft Methodology. The report analysis highlights the current significant challenges of relying on index-linked gilt data given trends in market pricing of index-linked and nominal gilts compared to the official forecasts and official policy statements that Ofwat proposes to rely on to estimate the risk free rate in the Draft Methodology.

SES supports the First Economics report conclusions that it would be prudent for Ofwat to look beyond just index-linked gilts at PR24 to a wider basket of proxies for the riskless assets and that Ofwat should give greater consideration to the CMA's PR19 redetermination that there is both a theoretical and a practical rationale for estimating the risk-free rate using a basket of assets comprising index-linked gilts and AAA rated non-government bonds.

The First Economics report also helps show that the concerns Ofwat has identified in its PR24 consultation document (about a seemingly counter-intuitive relationship between gearing and the cost of capital) may be primarily associated with the characterisation of the prevailing risk-free rate of return.

Read alongside the Oxera report, SES consider that Ofwat should give careful consideration to First Economics' findings and both reports support a rethink of Ofwat's RFR proposals ahead of finalising the PR24 methodology.

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

We remain highly concerned with retaining a fixed allowance for embedded debt. This does not reflect specific company circumstances and – for SES Water – does not take account of the significant impact of our historic RPI-linked debt issued in 2001. It was the right decision to issue this debt at the time and has benefitted customers in the low inflation environment for the past 21 years. While Ofwat continues to state that "companies remain responsible for their financing choices", retaining this view on 20-year plus RPI-linked debt in a high inflation environment for a company like SES Water is not appropriate. The regulatory requirement to move indexation of RCV to CPIH-linked, with our maintenance of an historic RPI-linked debt, accentuates this issue.

We welcome Ofwat's retention of a potential company specific adjustment to the allowed return on debt but limiting this uplift to financing diseconomies of scale at the point of debt issuance is not reflective of the severe adverse impact of the current high inflation environment on our embedded debt.

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?

We do not have any strong views on the options proposed for estimating the RPI-CPIH wedge for converting RPI-linked yields to a CPIH basis.

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

We do not agree with the proposal in to adopt a lower notional gearing at PR24. A greater role for equity at PR24 cannot be prescribed when – from an overall PR24 draft methodology standpoint – investors are taking on more risk for a potentially lower allowed return on capital.

SES strongly support the conclusions and findings in the Frontier Economics report on notional gearing (again submitted to Ofwat's Future Ideas Lab). Ofwat has not sufficiently or appropriately articulated the rationale and impacts of its emerging thinking on notional gearing. Ofwat's proposals to decrease the level of notional gearing for PR24:

- Risk introducing greater uncertainty into the regulatory environment (without any demonstrated benefit to consumers); and
- Have not been demonstrated to date as consistent with Ofwat's 'consumer' and 'resilience' objectives, as discussed in the Frontier Economics report.

SES agrees with Frontier Economics' conclusions that:

- There has been no empirical evidence to date to suggest that the current notional gearing level of 60% is inconsistent with the market evidence or provides insufficient headroom to face future uncertainty.
- Ofwat have presented no analysis to date to show that it has considered the issue of gearing notional gearing and financeability in the round, and that adjusting the notional gearing level is the best option for providing greater headroom.
- Other solutions to address uncertainties associated with climate change, for example via re-opener mechanisms or specific allowances (as adopted for network companies in the energy sector), are not a more effective solution than adjusting notional gearing (given the negative impacts ('costs') that Frontier Economics identify in their report from Ofwat lowering notional gearing).

Overall, SES consider that Ofwat's proposal requires considerably more substantiation and impact assessment, and that any decision must be based on an objective assessment of the empirical data.

Based on Frontier Economics' analysis and conclusions, Ofwat's proposal for lowering notional gearing does not appear to be the appropriate solution to the issues that Ofwat has highlighted in the Draft Methodology. Nor does SES' management consider Ofwat's proposal on gearing – equity injection – appear consistent with the direction of travel that Ofwat has signalled in the DM on the cost of equity. If a transition process is sought on sector gearing levels – which as discussed above, has not been objectively demonstrated as necessary by Ofwat – then this needs to be accompanied with a price control package that delivers a fair balance of risk and reward, in particular an allowed rate of return, that creates the right incentives for attracting new equity investment into the sector.

We do not generally object to the proposed approach for setting allowances for corporation tax, consistent with PR19, but we do think this needs to be reviewed in light of the tax policy under the new Prime Minister.

CHAPTER 8 ALIGNING RISK AND RETURN: FINANCEABILITY

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

Customers are materially more impacted by an actual company's financeability that the financeability of a notional company. It is in customers' interests, therefore, to assess the financeability on an "actual" basis as well as the financeability of a notional company. This is particularly true for companies such as SES Water, where the assumptions used to derive the notional company debt portfolio do not reflect economic reality. (For example, notional assumptions on proportions of index-linked in the opening balance sheet will not reflect SES Water's historical debt position.) Ofwat, therefore, needs to ensure that companies are financeable in the real world.

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

We broadly agree with the financial metrics in Table 8.1 in the consultation, noting that these are generally consistent with those used by the credit agencies. However, any metric that utilises a non-cash interest component (such as the FFO/Net debt – alternative measure) is flawed and is not an indication of financeability. A cash-based FFO denominator should be used and not reduced by non-cash items, such as the accretion amount on index-linked debt. Therefore, we do not agree with the proposed use of the FFO/Net debt – alternative measure.

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 agree that it is important to strike a fair balance between current and future customers. We agree that the ability to adjust PAYG and/or RCV run-off rates to defer to accelerate cost recovery needs to be maintained – in particular to profile bills to avoid a "Bill shock" for customers. Since use of such regulatory levers will ultimately impact bills for customers, we agree the evidence is required from customers on the chosen bill profile (through the willingness to pay research) incorporating PAYG and RCV run-off rate. Regardless of any range set by Ofwat on RCV run-off rates, the resultant bill profiles should be evidenced as acceptable by customers.

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

We have two concerns with the proposed approach. First, addressing any financeability constraints under a notional structure is flawed as it does not reflect the economic reality of the company, and addressing financeability constraints must be applied on an "actual" basis first. This is particularly true, where the notional structure does not encompass all the nuances that are relevant in the actual structure. Second, while Ofwat has emphasised the need to manage financeability constraints through equity and dividend yield solutions in the first instance, a variety of options must be considered and should not unduly be limited at this stage, including bill profile considerations.

CHAPTER 9 PROMOTING FINANCIAL RESILIENCE

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

We agree with Ofwat and its proposed standard set of scenarios for testing financial resilience, although – as noted by Ofwat – the flexibility remains for companies to apply specific scenarios where appropriate. We agree that it is important that a common scenario for higher inflation is included given the current economic climate and the relatively high proportion of RPI-linked debt in our historic financial structure, which was efficient at the time.

Q9.2 Do you agree with our approach to how the Board of the company should approach its Board assurance statement?

We agree with Ofwat and its overall approach to the Board assurance statement, ensuring that the statement sets out clearly the steps the board has taken in order to provide its assurance that the company will remain financially resilient under its business plan. Regardless of regulatory requirements, maintenance of finance resilience and associated plans to maintain or strengthen is regularly reviewed by our Board via our Financing Committee. It is important – as proposed by Ofwat – that flexibility remains to evidence targeted credit ratings for the actual company where those difference from those targeted for the notional company structure.

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

We broadly agree with Ofwat's proposed approach to dividend policies, performance related executive pay and voluntary sharing of financial outperformance, noting that such proposals align to recent feedback provided by Ofwat following the most recent Monitoring Financial Resilience Report in November 2021. We do recommend that Ofwat provide clear guidance on what exactly is considered a "gap" in such policies and reporting from review of the 2022 APRs, as for our Company we believe we have addressed all requirements by Ofwat in terms of dividend and performance related executive pay policies.

The above response is heavily caveated by the fact that Ofwat have yet to provide a view on the reasonable base dividend yield to account for the PR24 equity return or the allowed return for PR24. Further regulatory intervention on our Board's dividend policy while simultaneously lowering expectations of base dividend yields in a period where shareholder support for our long-term goals is more important than ever would not be acceptable.

Note that while we broadly agree with the proposed approach above, we have strong objections to specific aspects of Ofwat's proposals to strengthen the regulatory ring-fence which we have responded to via Ofwat's separate consultation on such matters.

CHAPTER 10 COMPANIES' PR24 SUBMISSIONS

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

From an overall standpoint – as described in 10.3 of the consultation – the PR24 submission requirements are clear. However, as specific sections of the business plan develop, further clarification will inevitably arise to ensure the requirements are sufficiently specified. This will be the case with the long-term delivery strategies, as the feedback sessions from Ofwat's early review in early 2023 may start to crystallise further the requirements in this new area of submission.

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

We have not noted any missing or superfluous submission data at this stage of the business plan process, however any new data requirements that come out of the consultation process should be communicated in advance of the final methodology.

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?

We welcome the qualitative limitations on business plan document and data submissions and have not further comments at present the level of prescription required.

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?

We agree with Ofwat's expectations for the Board's assurance and governance arrangements.

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?

We agree in principle with Ofwat's proposal to apply revenue adjustments for past performance across AMP 8. An overhaul of the reconciliation rulebook would be very welcome, particularly with regards to the table of contents and ensuring that the content is streamlined to allow ease of use. We would be happy to discuss this further with Ofwat.

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?

We agree with Ofwat's proposal to use a similar process for making 2024-25 blind year adjustments to that used for 2019-20 blind year adjustment in PR19. We do not have a strong preference with respect to either of Ofwat's proposals for dealing with 2024-25 in period ODIs for AMP 8 revenue – although the use of forecast data for the last year's ODI within the blind year adjustment, with subsequent true-up, as was performed at PR19, was acceptable to SES Water.

Q10.7 Do you have any comments on how to best deal with the impact of shadow and non-shadow reporting in table BIO3 on other tables?

Not applicable for SES Water.

Q10.8 Do you have any comments on the data we should collect in table BIO5?

Not applicable for SES Water.

CHAPTER 11 ENCOURAGING QUALITY AND AMBITIOUS BUSINESS PLANS

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

- **that we should first assess 'quality' followed by 'ambition'?**
- **with our proposed allocation of rewards and penalties for performance on each?"**

While we agree in principle with Ofwat's assessment of business plan "quality" followed by "ambition", we do have some key concerns on the basis and transparency of this assessment by Ofwat, primarily as it relates to determining the level of a company's "ambition" in the submission. Therefore, we recommend that:

Ofwat provides clear guidance on aspects of the business plan submissions that would "automatically" constitute an "inadequate" or "lacking ambition" plan. For example, while Ofwat notes that alterative allowed return on capital can be provided with evidence that such a rate "is more appropriate" than Ofwat's early view, we consider that there will be a reluctance to do so from companies for fear of being automatically deemed "inadequate" and left with no ground for challenging Ofwat's counterarguments on the allowed return. Therefore, without an initial assessment of business plans and the reputational risk that companies now run if their initial submissions are deemed inadequate or lacking ambition, companies need clearer guidance of such assessment criteria from Ofwat

While Ofwat's criteria on assessment the "quality" of business plans is fairly clear when considered in conjunction with overall draft methodology, the criteria for assessing "ambition" are not transparent and too subjective in terms of assessing "stretching but achievable" levels of services. The Final Methodology statement requires to provide greater guidance on this assessment by Ofwat and the early revies by Ofwat of companies' long-term delivery strategies in early 2023 must provide clear recommendations if such plans are not considered ambitious enough.

With respect to the proposed allocation of rewards and penalties for performance in Ofwat's planned assessment, we are concerned about the layering of penalties throughout the business plan process, for example from reduction in allowed return and base cost in addition to unfavourable symmetrical adjustment of cost adjustment claims.

Q11.2 "Do you agree with the proposed scope of our 'quality' assessment? Specifically, do you agree:

- **we should have minimum expectations in the six areas described above.**
- **with the minimum expectations we specify in each of the six areas?"**

We agree with the principle of having minimum expectation in each of the described areas for the "quality" assessments and also agree with such minimum expectations as documented.

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

While we agree on the overall proposed scope of Ofwat's ambition assessment, as noted above we recommend that Ofwat provide greater clarity on the specific criteria for this ambition assessment and – in the light of removing the initial assessment of business plans – utilise the early long-term delivery strategy feedback to provide companies with an early indication of sufficiency in this area.

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

To the extent that Ofwat is encouraging companies to make their first submission their best possible submission, we agree with the proposed reputational, financial and procedural rewards and penalties, including the overall package of reward and penalty. However, without an initial business plan assessment phase, the Final Methodology needs to address how to balance the threat of a submission being classified as inadequate with the need for companies to understand how Ofwat will consider evidence in submissions that deviate from aspects of their prescribed methodology (such as allowed return).

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

We have no further comments on Ofwat's approach to overall business plan submission incentives, although please see other parts of this response commenting on layering of these overall business plan penalties with other proposed penalties arising from the submission itself.

APPENDIX 6 PERFORMANCE COMMITMENTS

QA6.1 Do you have further views on whether the proposals laid out for C-MeX are appropriate?

We note that the current C-MeX methodology does not accurately reflect the relative level of customer service provided by a company, because customer satisfaction scores are influenced by factors other than the level of service received, including the level of affluence of the customers in the sample. To correct for this, standardized demographic samples could be used, to ensure scores for each company were on a more like-for-like basis.

We do not support the proposal in the draft methodology to remove the Check and Challenge process. While we only raise a small number of such challenges in each quarter, we routinely have a high percentage accepted and our modelling suggests that given the small differences in absolute scores between companies, these decisions can make a material difference. If Ofwat moves forward with its proposal to increase the level of risk and reward associated with this measure, it will be more important that all parties have confidence in the quality of the survey data on which it is based. For this reason, and as a greater percentage of contacts become digital, we would recommend expanding the Check and Challenge scheme to include all channels as an alternative.

We feel it is in the interests of all concerned that the process is of the highest possible quality and would gladly work with Ofwat and other water companies to identify and eliminate the root cause of any issues currently resulting in calls being excluded. Equally, while we do not recognise the risk of customers being contacted inappropriately as described in the document, we strongly agree that this is not desirable and would support work to eliminate it through other means.

We would need more detail to be clear on our view of the use of online panels as part of the methodology. It may, or may not, be appropriate but we do have a concern that customers may not feel it is a good use of their money to offer incentives in this regard.

We agree that any decisions about adjusting the measure to address possible biases must be based on data and would recommend considering data from other sectors/academic studies as well as within C-MeX data specifically. We would support further investigation of affluence as one potential bias as part of this, as well as the impact of metering programmes, as our data suggests that measured customers report lower levels of customer satisfaction especially when combined with other demographic factors such as affluence.

We would welcome the establishment of an industry working group to drive progress on these and other C-MeX issues raised by stakeholders to allow time for any required piloting and refinement in advance of PR24 Determinations.

Finally, we note CCW's observation that the number of complaints it receives about water companies has not fallen in the first year of C-MeX but do not agree that there is a need to put more weight on complaint numbers as a result. An increase in complaints may be driven by different factors, including greater awareness that it is possible to complain to CCW which is an outcome we have been working towards together, and as such is in many ways to be welcomed. External factors such as the link between the general economic climate and propensity to complain about bills also need to be considered, while attention also needs to be given to who is complaining about what, and how insight from complaints is being used to drive overall improvements in customer service.

QA6.2 Do you agree that C-MeX needs to adapt to provide better service to vulnerable and worse served customers?

We strongly agree with Ofwat that it is important for all water companies to provide a good service to all customers, including those who are vulnerable, and we agree that C-MeX as it is currently configured does not support a segmented understanding of performance in this regard.

Should Ofwat decide to address this through changes to C-MeX, we understand that segmentation would require an increased sample size in order to maintain the statistical significance of the results.

We note that that C-MeX is already made up of three separate elements. If Ofwat wishes to adapt the measure to include further aspects, we believe it is important to ensure companies can maintain a clear line of sight between the overall result and which issues to prioritise, and that colleagues are clearly able to understand the link between the measure and their actions.

We believe that the issue would be best addressed in conjunction with other measures, such as the customer-focused license condition that Ofwat is consulting on separately. We welcome the opportunity to be involved in the development of this license condition with Ofwat to understand how it can most effectively deliver against this objective.

We also note that SES Water has committed to delivering the British Standard of Inclusive Service within the timeframe covered by PR24 as part of a sector wide commitment to ensuring that vulnerable customers' are adequately considered in every aspect of our service.

QA6.3 What are your views on our proposal to introduce a single, combined common performance commitment ('BR-MeX') capturing the experience of both end business customers and retailers as intermediate customers?

We agree with Ofwat that a performance commitment directed at wholesaler performance in the non-household market could positively influence decisions, policies and investments, and ultimately contribute to improving the experience of non-household customers. However, we have a number of concerns that we would like to see addressed in the design of the measure.

First, we consider that the measure should be concerned solely with Wholesalers' interactions with Retailers (as intermediaries for end customers) rather than including end users directly in the measure or the BR-MeX survey itself. This is primarily because we believe that, even if the survey is carefully designed, end customer's responses are inevitably likely to be coloured by their overall experiences of the non-household market (including their experience with their retailer, with switching, with billing, etc) rather than their direct or indirect interactions with Wholesalers specifically. This means that Wholesalers' absolute and relative performance under BR-MeX would be influenced by factors completely outside their control.

Second, as a smaller wholesaler, we do not have the contact volume that the larger wholesalers get, both regarding bilateral processes and direct contacts. This may mean we cannot provide the sample sizes of 800 contacts. If the required sample was further split between retailers and end customers, we would be even more concerned about the representativeness of responses.

Third, we are concerned that issues which are outside of the wholesaler's control will impact the BR-MeX score if the measure is not designed carefully. For example, in the last financial year we received 268 bilateral requests, driven by retailer requests. If a retailer is unresponsive, these requests can result in direct contacts from customers. We have concerns over meter skips and the backlog of requests that have been known to occur with retailers, which causes settlement issues, partially due to bill shock to the end customer.

Finally, we are also concerned about the lack of clarity on data ownership in the non-household retail market and the lack of understanding of the Wholesaler and Retailer Codes among market participants. We are, in particular, concerned about the potential impact on the BR-MeX score of leakage adjustments which are erroneously presented to customers as a wholesaler's responsibility and of potentially avoidable non-primary charges for visits requested by a retailer could have.

How BR-MeX is designed and promoted to the end customer needs to be carefully considered and worded and we look forward to further clarification as to how this will be implemented. We suggest that an iterative design, trialing and piloting process (akin to the development of C-MeX and D-MeX) is undertaken on a collaborative basis with the industry to ensure that any performance commitment is robust in advance of adoption for PR24.

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

We do not have evidence to suggest that the current WSI performance commitment inhibits innovation.

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

We agree with the proposed definition of the biodiversity performance commitment. We would recommend that the frequency between surveys is set at five years rather than four, allowing for updates at the same point prior to the end of subsequent Price Review periods.

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?

The normalisation measure proposed in the draft methodology depends on a common metric being set between companies, so we agree that separate PCs based on water/wastewater activity could be a logical outcome. However, we are concerned that this outcome could lead to inconsistencies between the two PCs and propose that whatever methodology and metrics are adopted ensures that the resulting PCs are equally stretching and consistent regardless of which activity is being measured.

Another important consideration when developing this methodology is complexity. We think a metric that is measurable, transparent and proportionate while taking account of the latest evidence and best practice is sensible approach for this PC in PR24. The design of any GHG PC should reflect the ultimate objective of achieving net zero by 2050 and act as a clear staging post towards that goal.

QA6.7 Do you agree with our proposal that the performance commitment on serious pollution incidents should only apply to water and wastewater companies?

Whilst we agree with the principle of Ofwat's proposal to reducing the total numbers of performance commitments per se, being the only WoC at the current time to have a bespoke performance commitment around serious pollution incidents, we are disappointed that the draft methodology does not look to apply this measure to all water companies via a common performance commitment. We would therefore welcome the acceleration of the Environment Agency's proposed development and expansion of their annual Environmental Performance Assessment (EPA) reporting to incorporate WoCs alongside WaSCs, allowing greater overall visibility and comparative performance across the entire sector.

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?

No comment given that this question is directed to WASCs.

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

No comment given that this question is directed to WASCs

APPENDIX 13 DATA AND MODELLING

QA13.1 Do you agree with our proposed approach to mechanisms at PR24?

We agree with proposed approach to such mechanisms at PR24