Aileen Armstrong
Senior Director
Ofwat
Centre City Tower
7 Hill Street
Birmingham
B5 4UA

Cathryn Ross
Strategy & External Affairs Director
cathryn.ross@thameswater.co.uk

7 September 2022

Dear Aileen,

Creating tomorrow, together: consulting on our methodology for PR24

We welcome the opportunity to comment on the draft methodology. We agree with Ofwat's identification of the priorities and challenges for PR24 and we wish to work with you to address them. Consultations are an important element of the regulatory framework and we welcome the additional time that we have to respond, compared to PR19, as this allows for a more considered response.

As we set out in our response to *'PR24 and beyond – creating tomorrow together',* the context for PR24 will be challenging. The plausible scenario we indicated in our response, of high inflation, rising interest rates and an economy not yet fully recovered from the impact of the pandemic is very real and amplified by the Ukraine conflict. The cost of living crisis has developed during 2022, with the Bank of England in their August 2022 Monetary Policy Report expecting inflation to be in excess of 13% by winter with a long period of recession.

While this context clearly highlights the importance of affordability, the challenges facing us from climate change are only increasing. This is illustrated by this year's drought, which has been accompanied by further flooding in London, on the back of last July's unprecedented flooding. And beyond this, there remains also the need to improve the environment (particularly river quality) to plan for population growth and address ageing assets, all the while improving services for customers.

All this makes it all the more important that the PR24 final methodology utilises fresh thinking and introduces real change to enable and incentivise companies to identify efficiency and innovation that will ultimately allow us to deliver the outcomes that customers and society want on a long-term sustainable and affordable basis.

There is much that we welcome within the draft methodology to address these issues, for example, the focus on the long-term, the more targeted approach to performance commitments and the changes to facilitate nature-based solutions and achievement of Net Zero. However, there are a number of areas where we consider the proposed methodology falls short or where it could go further, for example in relation to multi-AMP programmes and facilitating greater levels of expenditure on capital maintenance, replacement and upgrade of assets. We also have some areas of concern, for example with respect to the clarity of the equity story, given the essential investment that will be required.

We provide further details on these issues below and respond to the detailed questions in the attached completed template. While we have completed the "agree/disagree" option from the template, this simple response cannot do justice to the questions raised and needs to be read in context with the comments we make.

A focus on the long term

We have supported the increased focus on the long term as an important step in providing what customers and society need in a sustainable way. Remaining focussed on the long-term is even more important given the significant challenges highlighted above. A focus on the long term opens up choices about how delivery may best be sequenced over time, to improve efficiency and maintain investment while keeping bills at an acceptable level. We therefore agree that companies should ground their business plans in the context of their longer-term strategies.

In our response to *'PR24 and beyond – creating tomorrow together'* we highlighted the benefits of companies taking a genuinely long-term approach and encouraged you to include some measures to incentivise delivery of outcomes over the long term, beyond a single price control.

We therefore welcome the commitment to facilitate multi-AMP programmes: "*We will facilitate long-term investment through greater clarity on the treatment of multi-period investments and outcomes.*" This has the potential to unlock significant benefits for customers and the environment. Agreement from Ofwat on the objectives of these programmes (in terms of outcome delivery) and the broad scope of work needed as part of a multi-AMP programme, could provide a framework that would open up a different set of solutions, with more innovation and efficiency. In particular, that clarity would enable us to enter into different relationships with the supply chain so that they could build the capability around, for example, nature-based solutions or sustainable urban drainage solutions. It would also encourage local stakeholders to work with us over the long term and invest in the enablers needed to take a different approach, for example, to drainage planning or catchment management. The multi-AMP programmes we have in mind would deliver benefits over the long terms, for example in relation to London's water resilience, London's surface water drainage or the management of wastewater in catchments in the Thames Valley. The contribution they would make to physical and natural capital suggests that their cost would reasonably be recovered over the long term, through the RCV, enabling these major programmes of work to be delivered in an affordable way. We would be happy to work with you to develop these processes, building on our experiences through our conditional allowances.

Long-term focus on capital maintenance and replacement

One area where it is important that over the long-term the industry steps up its investment is in relation to capital maintenance and replacement, to underpin more resilient services to customers over the long-term. We very much support the work you are doing to improve focus on asset health. We welcome the considered approach Ofwat are taking through the creation of the operational resilience working group. However, this should not be a reason to delay taking important decisions to improve asset health and to enable the funding needed to achieve this. As the Environmental Audit Committee recently noted, *"a step-change in regulatory action [and] water company investment…is urgently required*".

In response to this issue, Water UK commissioned a report from Economic Insight. Their report highlights that the long-term successful delivery of high quality and reliable water services requires resilient assets. This is consistent with Ofwat's recent comment in its discussion paper on operational resilience, that, *"it is critical that water companies have assets that are well maintained and operate as intended so that they meet the requirements of their statutory obligations and the expectations and needs of customers, the environment and wider society."*

Their analysis shows that current rates of replacement are below the long-term sustainable level. They highlight, for example, that the England & Wales water mains replacement rates are one tenth of the European average and that UKWIR has projected that, if no action is taken to increase the level of asset maintenance and replacement, service quality will deteriorate significantly by 2050, such that: water mains bursts will increase by 20%; the number of interruptions to water supplies will increase by 25%; and sewer blockages and collapses, and the resulting flooding and pollution, will increase by 6%. It also highlights, that multiple stakeholders have indicated that climate change and population growth are likely to create additional future pressures on water assets.

They consider various options to reform the regulatory framework to deliver the step-change in funding required through the price control; and appropriately balance the twin objectives of promoting investment, while ensuring efficiency.

We endorse the report produced by Economic Insight and urge Ofwat to consider its recommendations in the final methodology, in particular the option of a dedicated cost allowance for asset maintenance and replacement. This will also help address the issue of cost models based on historical data not being reliable for the different challenges of the future. It is imperative that Ofwat take account of the impact of climate change, not just in respect of changes to average temperatures and weather conditions, but also in respect of a greater frequency of extreme weather events, on asset maintenance policies if current levels of resilience are to be maintained. In our view, it would be reasonable for Ofwat to support any such dedicated cost allowance with the delivery of specific outcome- or output-related measures of asset maintenance and replacement, enabling the regulator and therefore customers and stakeholders to be confident that this funding was being spent on the intended purpose, to improve long term asset resilience.

Long-term focus on the environment

Environmental needs are important to customers and communities and need a long-term approach. We welcome the encouragement for nature-based solutions in the draft methodology and look forward to seeing more details in the final methodology, which we are happy to work with you to develop. If we are to build nature-based solutions into our business planning, we do need more clarity on how Ofwat will approach their funding (pay as you go vs RCV, for example) and any performance commitments and ODIs that depend on them (given that their performance might be less certain and predictable than 'grey' assets).

Achieving Net Zero and mitigating global warming is clearly an increasingly urgent and important goal for society and so we also welcome the encouragement for this through the draft methodology, albeit further details need to be developed. However, we consider that the proposal to use a location-based performance commitment metric, rather than market-based metric, limits innovation and does not provide the incentive to take the most effective actions. We believe that using the market-based approach represents the best way to incentivise actions that will have a long-term impact on the water industry's emissions. In addition to directly reducing GHG emissions through the development of low-carbon investment solutions, energy efficiency and energy recovery from waste, the business also takes active decisions to purchase green electricity generated from renewable sources to offset the emissions associated with the electricity we use. The market-based approach will also move the focus on to long-term actions to tackle emissions that cannot be reduced through grid decarbonisation and open up opportunities to support the decarbonisation of the gas grid through government incentives.

Affordable outcomes for customers, communities and the environment

Given the challenges set out above and the current cost of living crisis, it would be understandable if Ofwat were to focus on keeping bills as low as possible in PR24. While it is clear that efficiency and innovation are to be encouraged, it is important that Ofwat should not limit the scope of the work that is needed in AMP8 to secure resilient service provision for customers and environmental improvement. Put simply, if we do not invest today to improve performance and resilience in the face of climate change, we will all end up paying a higher price, through more, and more extreme, service failures in the future, which will affect customers, communities and our economy.

If bills overall are to rise to fund the investment that is needed, assistance for those who would struggle to pay those bills is critically important. Social tariffs will help up to a point, but now is the time to move the focus away from annual changes in average bill as the way to assess affordability at price reviews and to instead focus on developing progressive tariffs and better support for those who may struggle to pay.

Another important way in which Ofwat can square the need for more investment with affordability constraints that are particularly acute at the moment, is to use its ability to spread the recovery of cost over the long term. We are concerned that in the draft methodology it is suggested that Ofwat may set a narrow band of PAYG and/or depreciation run-of rates that would make it more difficult to spread the cost of critical investments that are needed now to avoid even higher costs in the future. While we understand that Ofwat will rightly be concerned not to put too much cost on the 'credit card', we consider that where investment will genuinely result in benefits over the long term, it is reasonable to spread the cost over the long term. We urge more flexibility in this area in the final methodology to help companies manage the current affordability challenges without compromising investment.

Taking into account of the cost of living crisis, we are very disappointed that Ofwat has decided not to include a common PC that relates to companies' identification of and support for vulnerable customers. We understand that Ofwat intends to pursue this objective by other means. But we are concerned that not including vulnerability within the suite of PCs and ODIs – which are a key focus for the industry – will give the impression that the issue is being downplayed. We consider that excluding vulnerability from that framework is a missed opportunity. Specifically, we are concerned that if Ofwat, for example, moves to address the issue through a licence requirement, this will create a compliance mindset about vulnerability, rather than stimulating companies to be creative and sector-leading in an area where this sort of thinking would be very valuable.

A focus on long-term enduring outcomes

As highlighted above, it is essential that companies focus on long-term key strategic objectives. So, we agree with the focus on fewer enduring performance outcomes with common definitions. However, it is important that companies are encouraged to innovate and address specific issues in their areas. In this context, we consider that the limitation to 2/3 bespoke performance commitments per company (we assume our TTT measures would be in addition) is potentially too restrictive. In addition, we have concerns about the proposed extensive use of output-based PCDs as this could encourage companies simply to deliver the specific solution included in its business plan without further thought. This may have the unintended consequence of limiting innovation and efficiency and would be better replaced with bespoke outcome-orientated performance commitments wherever possible.

Part of the power of the PC and ODI framework is that for most PCs the targets that companies need to achieve or exceed are clear in the final determination. However, for customer service outcomes, C-Mex, D-Mex and BR-Mex Ofwat employ an annual benchmarking approach. While this approach has its benefits it also has its disadvantages in that companies can become entrenched in a position and lose the incentive to improve. A company that is always bottom pays the same penalty no matter its level of performance and no matter whether that level of performance has significantly improved. We therefore consider that the existing mechanisms could be supplemented with a mechanism that rewards the most improved companies even if their positional ranking does not change. This would ensure that there are strong incentives on all companies to improve customer service. We also strongly advocate increasing the sample size of the C-Mex survey so that the quarterly results are more representative, reflecting the communities we serve, including vulnerable customers.

Improving river quality is an important objective for customers and communities and we agree with the introduction of the river quality common performance commitment. The design provides the right incentives on companies, as it focuses on the contribution to “good quality” river status that companies and their partners can deliver in terms of phosphorus removal, rather than the overall state of the river, which can be materially affected by other parties.

The issue of spills has increased in prominence recently and we have been very clear as a company that any spills are unacceptable. We therefore agree that there should be a common performance commitment for spills as it will take time, given scale and complexity of networks, for the issue to be “managed” out of existence. However, we believe that Ofwat’s ambition to deliver greater environmental and social value and best outcomes for customers and communities, would be best served by providing incentives to reduce harm from spills rather than simply the number of spills. This would also be more aligned with Defra’s consultation on Storm Overflows, which asks companies to address “high priority” sites in priority to other, potentially more frequent spills. A further concern is that Ofwat are proposing a common performance target, which would not recognise the different starting positions of companies. For example, due to the harm level, companies with bathing or shellfish waters have been funded through WINEP schemes to reduce spills. We therefore consider that, while all companies should have a performance commitment on this, the level of the targets should be set on an individual company level rather than as a common value, which would also avoid distorting incentives with a common target easy to achieve for some and impossible for others. While we recognise the tension with an outcomes-focussed approach, Ofwat must also take care to ensure that the PCs and ODIs in this area reflect real improvements made by companies, rather than, for example, the effect that dry weather will have in reducing spills (or wet weather will have in increasing spills) regardless of company action.

As the current drought is highlighting, resilient water supplies are very important to customers. We therefore welcome the continued approach to developing long term water resources strategic supply projects through RAPID. It is also important that companies take all the action they can to manage the demand side and minimise leakage and reduce consumption. We therefore fully support the continuation of a separate leakage performance commitment. We have raised concerns previously in our response to '*PR24 and beyond – creating tomorrow together*' and through the outcomes working group that the PCC measure does not fully incentivise companies to do all they can to promote water efficiency. It is too heavily influenced by factors beyond a company's control or influence. The increased use of smart meters makes it possible to have a robust water savings measure that reflects the savings arising from the actions taken by companies and their partners. We provided Ofwat with a potential methodology, on 17 June 2022, to assess the impact on water consumption of companies' actions that would support a water savings delivered performance commitment. We urge Ofwat to consider this option further. This approach would provide a stronger incentive on companies to take action to reduce consumption for both household and business customers.

Given the importance of reducing consumption, we strongly welcome the introduction of a business demand common performance commitment. However, we do not think measuring 'percentage reduction from a baseline' is appropriate as such an approach will be significantly distorted by growth, weather etc. rather than reflecting water companies' activities. The recent Covid pandemic illustrates the potential pitfalls of a PC defined in this way. We also strongly disagree with the exclusion of the largest companies from the measure. Such an exclusion would be a huge missed opportunity and would disincentivise water companies from engaging with large users to deliver material demand reductions. All users of water need to be encouraged to reduce consumption and large companies should not be excluded simply because a poor metric design would give water companies an unearned reward if a large business closed. Rather, it would be more effective if the incentive were change to only reward companies for savings arising from their actions, as set out in the methodology we provided.

The application of deadbands on CRI and discharge compliance and caps/collars on weather affected performance commitments ensures that commitments are stretching but achievable. Without these risk mitigation mechanisms there is a real risk that the effectiveness of these incentives is undermined as one or two events would make the commitment unachievable. It will also result in ODI returns being strongly skewed to the downside, which would need to be reflected in the allowed return, a point we return to later.

Enabling and encouraging high quality business plans

To deliver the outcomes that customers and communities want over the long-term, while dealing with the challenges we all face in terms of the need for substantial future investment, requires high quality business plans.

We therefore agree with the more streamlined approach included in the draft methodology, with the PR19 initial assessment of plans (IAP) and draft determination combined into one stage, and with the more focussed assessment areas, of quality and ambition. For this two-stage process to be effective, the draft determination should be published earlier than traditionally, we suggest April 2024, with responses due in early September. This would allow companies to have enough time to consider and engage with Ofwat on the feedback and respond accordingly to ensure even better final business plans are produced to enable delivery of long-term improvements for customers and the environment.

As we highlighted in our response to '*PR24 and beyond – creating tomorrow together*' the business plan assessment process would be more effective if Ofwat could provide early sight of its views in some key areas, such as base expenditure, performance commitment levels, incentive rates and the WACC. It now looks very unlikely that we will have this information (apart from the

WACC) in time to materially influence business plans. This therefore increases the chance of misunderstanding between companies and Ofwat and makes it even more important that companies will be able to engage with Ofwat following draft determination. Where improvements in the business plan are made, there should also be an opportunity to improve the business plan categorisation. This will provide the incentive for companies to respond positively to the draft determination.

We have been supportive of the collaborative national research approach but the timing of results from this are not helping the development of quality plans. We highlighted in our response to *'PR24 and beyond – creating tomorrow together',* that, given the importance of this research in informing the development of business plans, to be useful for business planning we would need any information from customer research on customers' valuation of different levels of performance in different areas by the start of 2022. We are now unlikely to obtain the results of this until winter 2022/23 which will affect the extent to which they will influence business plans. We ask Ofwat to take this into account when assessing how companies have brought the results of the research into those plans.

Markets, innovation & efficiency

Markets can be a positive way to enable and provide incentives for innovation and efficiency providing they are properly designed and operated. As we set out in *'PR24 and beyond – creating tomorrow together'* we agree with the long-term objective of removing contestable connections from the price control framework. So, we welcome the proposal to remove most new connections from price controls. However, we are concerned about the proposals to set a threshold of 25 premises for developments to be outside the water control, as we do not believe that the number of properties in a development is a key driver for competition in this market. Other factors such as construction complexity, pipe size and surface type (ie greenfield vs brownfield) are much more important to self-lay providers and NAVs when targeting their business development activities. The threshold could cause confusion and undue complication, which risks losing many of the benefits of the market. We propose that all connections are removed with protection for very small developments provided via charging rules, as required.

Bioresources is an area where Ofwat consider there is potential for substantial market development. We are less confident that all the elements for competition to develop are in place to allow substantial market development in the short-term, but we are keen to help develop markets as far as is possible. While we welcome the clarification that the bioresources asset value will be included in the stated RCV, we have concerns over whether the proposed new approach to modelling average revenue, rather than cost, will be robust and it will be important that it is clear how companies will obtain a nominal return without an indexed RCV. We are very happy to work with you through the cost assessment working group in developing robust models.

Competition for major projects has the potential to bring new ideas into the industry and so welcome Ofwat's call for a relaxation in the conditions for SIPR projects and the increase in the threshold for direct procurement for customers (DPC) projects to £200m to allow more focus on these larger projects. However, we are very disappointed that Ofwat has decided not to allow incumbents or associates to bid for these projects as it would have provided additional competition to ensure best value solutions were selected. Customers would also have benefitted from the learning that incumbents would get from bidding into a DPC programme and comparing their own costs with those of other bidders. We would urge Ofwat to reconsider this policy decision. Where there are large programmes that are not suitable for DPC, we continue to consider that there may be merit in considering varying the returns available reflecting the scale, complexity and risk profile of a company's proposed programme. This feels to us a more targeted way to appropriately reflect risk and is particularly important as Ofwat tightens the base WACC, increasing the possibility that for companies with large capital programmes (and therefore equity risk that is higher than the 'notional' company) the cost of equity in the base WACC may not be sufficient to remunerate the risk in their specific plan. We set out some thinking in this is our paper "Regulatory options for complex projects", which is published on the new Ideas lab webpage.

A fair return is essential

Economic regulation is fundamentally about the allocation of risk and enabling an associated return which fairly compensates investors for bearing such risk. It is right that Ofwat should seek to allocate risk to whoever is best placed to manage that risk, as this will incentivise the most efficient management of the risk. But it is imperative that Ofwat's price controls allow investors a reasonable return, which appropriately compensates them for the risk that they will bear. This is particularly important given the scale and nature of the investment the sector requires to meet future challenges as well as changes to the regulation which are likely to increase volatility of returns for companies.

In calibrating an appropriate return, it is therefore essential that Ofwat undertake a more thorough risk analysis, using RORE or another recognised method. There are a number of proposals within the draft methodology that will increase the volatility of returns or result in an asymmetrical downward skew to RORE. The proposed removal of most caps and collars from performance commitments will increase volatility, particularly to weather, which with climate change will only become more extreme and result in asymmetrical returns. The removal of deadbands will also result in ODI returns being strongly skewed to the downside. In addition, the proposal to set a higher base cost efficiency level (85th percentile) and performance commitment stretch through base expenditure is likely to make achievement of base returns more difficult. Even if, in theory Ofwat's incentives for outperforming and underperforming the performance commitment level are symmetrical, the extremely challenging level at which the commitment is set is likely to mean in practice that the expected distribution of returns for most companies is skewed to the downside. We note that in the first two years of the current price control period only two companies have managed a cumulative positive ODI return, and targets will only get more stretching as the period progresses. In addition, the absence of indexation on the retail price review increases risk in times of high inflation, as the current period is demonstrating. Taken as a whole, these factors look likely to result in a significantly downward skewed RORE, which is not currently reflected in Ofwat's analysis of risk ranges. Ofwat have stated that they will, in contrast to the CMA in the water redeterminations, aim for the middle of the WACC range. However, given the likely downward skew from the changes set out above this would no longer appear to be tenable and either Ofwat will need to aim up on the cost of equity, as the CMA did, or moderate the changes above to reduce the downward skew at source.

At PR19 four companies appealed to the CMA and the resultant changes to the cost of capital approach provided the opportunity for there to be a platform for a stable methodology and set of principles for the water sector. It is disappointing that Ofwat have chosen not to follow the methodological changes made by the CMA and to select a cost of debt approach that appears to minimise each element of the embedded cost of debt. This risks setting a cost of capital which is lower than even a PR19 FD equivalent level at a time where there is greater need to access equity capital to secure investment and de-gear. An approach that does not reflect the actual cost or provide for a fair return on capital, and a lack of predictability in this part of the regulation more generally, will not be in customers interests in the long-run, particularly given the need for significant investment over the long-term. Given Ofwat's intention that many companies should bring in additional equity, we would urge Ofwat, as we did in our response to the earlier policy consultation, to set out clearly how its regulatory approach will maintain the attractiveness of the sector to equity.

The approach to the cost of capital and risk in the price review cannot be considered in isolation from other initiatives that Ofwat are progressing. The current consultation on changing the ring-fence licence conditions will have an impact on overall equity risk. In particular, the proposal to increase the level at which lock-up is applied to BBB/Baa2 with negative outlook, is a significant transfer of risk from debt holders to equity; it provides additional protection for debt by curtailing the returns available to equity even where the company is maintaining a credit rating that is deemed to be sufficient in company licences. This will need to be matched by an increase in the cost of equity or the sector will be less attractive to equity. These proposals also increase the perception of regulatory risk as they are a significant change in approach, made without a full impact assessment on the industry or equity investors and as highlighted in the consultation document *"No water company or equity investor that responded to the discussion paper expressed support for raising the trigger to BBB/Baa2 with negative outlook*".

We are further concerned that Ofwat's proposals in this area will not help to address the key financial resilience issue that the sector faces. We agree that some companies, Thames Water included, need to improve financial resilience by de-gearing. But this measure is not an objective, targeted or proportionate way to achieve this. We also agree that dividends paid by companies should reflect performance and resilience delivered for customers and the environment, but we note that Ofwat has other means to achieve that goal. In addition, Ofwat's proposed approach may also result in the unintended consequence that that funds that could be used for investment may need to be retained to maintain a particular credit rating so that the lock-up does not occur. We will respond to that consultation in due course but wish to flag here that these wider developments also impact on the assessment of the price review methodology and will need to be taken into account in the price review.

Overall, there are certainly many positive features within the draft methodology. We look forward to working collaboratively with you as you develop the final methodology to ensure it provides all the right incentives, including incentives for equity investment, to deliver improvements both in performance and resilience for customers and the environment in AMP8 and over the long-term.

Yours sincerely

Cathryn Ross
Strategy and External Affairs Director