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7 September 2022

Dear Ofwat,

RE: Yorkshire Water's response to Ofwat's Creating tomorrow, together: consulting on our methodology for PR24

Thank you for the opportunity to comment on Ofwat's draft methodology for PR24, and for the ongoing engagement with the industry.

Our responses to the detailed consultation questions have been returned as requested. Please see document 'YKY PR24 draft methodology response.xlsx' attached. Please note, in response to some questions, we have provided additional detail within annexes to this letter.

There are many elements of the PR24 draft methodology that we support. We welcome Ofwat's focus on integrating strategic planning frameworks into the long term planning approach, and recognition of whole life costs and best value outcomes, for example. We are supportive of innovation and market based approaches, including for example the use of DPC, where the evidence clearly demonstrates improved outcomes for customers.

Within this letter however we have set out where we believe the methodology needs further development, where information is currently missing, and finally where we consider the need for reconsideration of approach, to ensure that the PR24 settlement represents a 'fair bet' for investors with both upside opportunities and downside risks.

PR24 represents a unique opportunity to address many of the significant long term challenges facing the sector and society more generally. We are supportive of Ofwat's four inter related ambitions identified for PR24 that recognise that the regulatory framework can no longer exclusively centre around the five year price review cycle and that the sector needs a wider vision and framework encompassing the value companies deliver to customers and the environment over the long term. We believe however that the PR24 draft methodology needs to go further to incentivise the scale and pace of change required to address the challenges we face while recognising the implications for intergenerationally fair bill levels and affordability constraints for an increasing proportion of customers. In addition, to the challenges and ambitions raised by Ofwat, the framework needs to address the urgent requirements for environmental improvements (such as CSOs), delivering net zero and sustainable approaches to asset health.

We have interpreted from the draft methodology that innovation, productivity gains, and improved efficiency, coupled with lower costs of finance, are proposed to resolve the challenges facing the sector. We recognise that ongoing innovation, productivity, and efficiency gains are particularly important, however increased investment is still needed urgently to meet the challenges facing the sector. The methodology therefore needs to consider the appropriate incentives required to attract and retain investment across the industry.

Whilst we agree with the continued use of the three building blocks outcomes regime, costs assessment and risk and return framework, we continue to be concerned that the approach does not take account of the interactions between the building blocks. We acknowledge Ofwat's proposed assessment of business plan ambition to consider "*stretching but achievable levels of service at an efficient cost to customers*." However, in setting what constitutes stretch for each company, Ofwat also needs to consider the performance commitment level (PCL) targets in the context of each company's asset base, historic performance, spend and enhancement allowances.

The draft proposals set out are creating increased downside risk compared to PR19, which the proposed business plan incentives potentially exacerbate. The increased asymmetry of risk and return created by the proposals, such as the removal of deadbands for performance commitments, and the exclusion of external factors such as weather events, need to be reconsidered to achieve a more balanced position within the risk and return framework or alternatively an increased cost of equity made explicit. Similarly, Ofwat's proposals should be able to clearly demonstrate an Outcome Delivery Incentive (ODI) neutral position is achievable for the notional company. It is important that the 'fair bet' principle is restored with any increase in penalties balanced by increased scope for earning rewards, or by including an adjustment in the cost of equity calculation.

This concept of a 'fair bet' extends into assessing the allowed return and the true financeability of the notional company. In this respect, we are concerned to see the apparent rejection of the Competition and Market Authority (CMA) conclusions on the PR19 referrals as it is the most recent regulatory determination and, importantly, adopted an 'in the round' basis of assessment. This concern also extends to the proposed changes to the notional capital structure, which have been presented as a matter of regulatory judgement but without any supporting analysis that provides a compelling rationale for increasing the gap on gearing between the notional company and the water sector as a whole.

While we appreciate Ofwat's principle for driving 'comparative' competition between companies, we see that a potential risk of this approach is that the sector becomes splintered with an increased gap in performance between companies. This could negatively impact some customers and local environments. We cannot see how this type of outcome is helpful for the industry at a time when we need greater incentives to work together, collaborate, share best practice, and stand together as a sector that can succeed and deliver. The package of incentives should positively incentivise all companies to improve outcomes for all customers.

The remainder of this response sets out our high level views on areas of the draft methodology where:

- development is needed
- information and detail are needed
- proposals need to be reconsidered

It is important for companies to have visibility of all elements of the proposed regulatory framework in order to provide a fully considered response. As there are elements of the methodology that remain to be finalised, our ability to constructively assess the methodology in the round is therefore limited and our ability to respond to the incentive framework, in developing our plan, is compromised. We look forward to the points raised below being addressed through ongoing dialogue with companies prior to publication of the final methodology. We welcome continued engagement with Ofwat in the coming months to ensure that the final PR24 methodology enables companies to successfully address, at pace, the immediate and long term challenges facing the sector and delivers positive outcomes for all.

Areas that need further development

We welcome Ofwat's intention to reward companies that work in collaboration with other parties. However, to enable greater environmental and social value to be delivered the methodology needs to ensure a level playing field between nature based schemes and more traditional approaches. The methodology is currently noticeably light on any detail in this space including approaches to catchment and partnership solutions.

Stronger incentives are required in these areas. Implementing these approaches effectively would enable the greater social and environmental value, which Ofwat sets out as a priority, to be delivered. The PR24 draft methodology does not provide the approach or clear incentives for companies.

As an example, we are disappointed in Ofwat's view that any environmental and social benefits are identified as part of companies carrying out their statutory functions only. The challenges we face from climate change, population growth, cost of living, biodiversity net gain, amongst others, requires us to work in partnership across catchments and across organisations. As a minimum, the final methodology should reflect the wider role of companies for customers, communities, and the environment. In doing so, the methodology should enable the agility needed for companies to maximise partnership opportunities to seek value beyond just their statutory functions. We ask that Ofwat reconsiders its proposal to benchmark third party contributions and instead ringfence programmes, with appropriate governance arrangements, to allow companies to draw on this over the AMP in response to opportunities presented.

We welcome that Ofwat is considering specific net zero enhancement funding and reflecting the climate emergency. We are concerned however that the approach proposed by Ofwat does not support the scale of ambition needed to meet the net zero challenge. There is a significant amount of detail missing from the proposals to provide a fully considered response. It is essential for PR24 and beyond, that clear guidance is provided for example on how to balance the trade offs between 'best value' solution and solutions that deliver towards net zero.

Within the cost models, the form, aggregation, and scope, as well as the variables being used, are key inputs to the price review process. We believe there is time and scope to continue to engage with the industry and we are encouraged in this case to see that Ofwat intends to consult further on the development of its approach and final form, even if the outcome will be extremely late in the business planning cycle.

We caution against making firm decisions on cost model form, aggregation, and variables without testing against PR24 datasets. If more robust models of a different form can be developed, then these should be used. While the CMA review at PR19 did not find fault in Ofwat's approach for cost modelling, Ofwat itself set out that PR19 modelling decisions were made based on the data available at that time (i.e., exclusion of a Water Resources model). Ofwat will now have access to a richer, larger dataset and should not be constrained by the choices made at PR19.

It is also true that modelled allowances were sensitive to using the latest datasets available. Given the influence of input datasets on the cost modelling outcomes we encourage Ofwat to ensure when developing its Botex+ models that the analysis effectively reflects the current cost pressures such as chemicals, raw materials, labour, and energy being experienced by the industry.

Ofwat needs to ensure a forward looking and long term approach to asset health is achieved at PR24, recognising there is a need for a step change in the level of asset maintenance and replacement needed to secure future asset health and service resilience. Regulators and companies need to ensure that the sector is on a long term sustainable path. The draft methodology currently does not recognise this as an issue. Ofwat's approach contained within its proposals continues to assume that historical expenditure has been sufficient to maintain asset health. We maintain our position that this is not the case.

Whilst some indirect indicators have shown improvement over time these often reflect improved operational resilience and response, and not the underlying asset base which is not being replaced at the long term sustainable rate.

Water UK has worked with Economic Insight and the industry to identify some clear trends that a step change is required to past capital maintenance allowances and asset renewal rates. The outcome of the work suggested potential solutions to this issue could involve a combination of Price Control Deliverables related to specific projects with dedicated totex allowances. Each allowance could have specific totex under/outperformance sharing rates to incentivise efficient delivery and to ensure all funding is invested exactly where it is intended.[1]

We welcome that Ofwat has recognised a limitation in the ongoing allowance for enhancement expenditure that may disincentivise nature based solutions. However, we believe that this limitation is wider than just nature based solutions and is an issue for all 'best value' enhancement schemes that carry significant expenditure into future periods that will not be reflected in Botex modelling. We think there is an opportunity to further develop this approach using a '10yr allowance' solution, to ensure that the benefits of enhancement expenditure can be delivered efficiently into the long term. We have provided more information in our detailed response in the Annex 2.

Areas where the final methodology needs further information and detail

In some major areas there is not yet enough detail to be able to fully assess the implications of the methodology. We would take this opportunity to encourage Ofwat to engage with industry and share its developing thinking. This is particularly important when we consider enhancement investment and the widely understood view that the industry needs to invest more to address the significant challenges outlined at the start of this response.

We will respond separately on bioresources, as requested, but believe that the radically novel approach contains many elements which will need significant development and testing and may not achieve the outcomes that the change is aiming to deliver.

We welcome the detailed steps to how enhancement cases will be assessed but very little has been shared on the approach to assessing efficient costs. It is also unclear how uncertainty in the required scope of enhancements will be managed and mitigated which is a further additional significant risk for companies. This is particularly important, for example, on storm overflow reduction where the government will review progress in 2027 which could lead to significant additional obligations mid period. We believe the inclusion of specific uncertainty mechanisms would help to manage this known issue ahead of time. This is an uncertainty that has already played out during this

[1] https://www.water.org.uk/publication/options-for-a-sustainable-approach-to-asset-maintenance-and-replacement/

price control already e.g., in relation to the newly published requirement from Defra that companies must monitor the water quality impact of their overflows upstream and downstream of the overflow. This demonstrates the need for an uncertainty mechanism to address likely future requirements.

We are deeply concerned that the draft methodology does not yet discuss Ofwat's proposals for assessing three crucial elements of cost assessment, namely catch up efficiency, frontier shift and the protection against real price effects. These are crucial and influential elements of the overall cost assessment that will have a material impact on the overall risk and return profile of the determination.

It is important that the catchup efficiency benchmark is determined by an objective assessment of the quality of the econometric models rather than on a desire to set an arbitrarily stringent efficiency challenge.

We urge Ofwat to share its thinking on frontier shift and particularly real price effects given current inflationary pressures such as chemicals, raw materials, labour, and energy. Furthermore, consideration by Ofwat is needed for a specific uncertainty mechanism to address the uncertainty regarding future energy costs.

While we are supportive of the proposed scope for the ambition assessment of business plans, there is not yet a level of detail that is useful for companies to inform the preparation of their business plans. Further clarity and transparency as to the criteria for the ambition assessment is therefore urgently required.

Areas in the draft methodology which need to be reconsidered

We strongly encourage Ofwat to reconsider the overall draft package of proposals for performance commitments, ODIs and costs. The approach set out in the draft methodology creates increasing asymmetric risk to companies. The removal of caps, collars and deadbands on individual ODIs will primarily impact companies on the downside (e.g., the default position will be for companies to be in penalty, please see our response to question 6.5 and 6.6). This does not represent a 'fair bet' for investors and will therefore make it more difficult and costly for companies to raise funds for new investments.

While we recognise that Ofwat is under increasing pressure to hold companies to account for performance, the proposed blanket removal of all extreme event exclusions will result in companies taking on open ended liabilities fully exposed to events that are driven by extreme weather or other factors outside of management control. This is in an era of climate where these types of events are becoming more frequent. The exposure to extreme events and increase in unremunerated risk would therefore undermine investor confidence in the sector, at a time when further investment is necessary.

Asymmetric risks are also evident in the approach to setting performance targets and cost allowances. There is an apparent expectation that ongoing service and environmental improvements can be delivered without incremental costs for customers. This is unsustainable and not consistent with the recent water sector redeterminations, where, for example the incremental costs required for delivering a step change reduction in leakage were recognised. The assertion that the cost of achieving levels of performance can be met from allowed base costs and further assumed efficiency gains, creates a significant downward skew to the risks facing all companies. For example, if companies are expected to improve efficiency at e.g., 1% p.a., they can *either* reduce expenditure by 1% p.a. or improve service performance, but not both.

Cost allowances for AMP8 need to consider current and future forecast cost pressures to ensure appropriate funding allowances. Additional costs of achieving further improvements in performance levels or the costs of inflationary pressures on retail services must also be explicitly recognised. This could include the indexation by CPIH of allowed revenues within household retail services in line with non household retail services.

Regarding PCLs, following on from the Setting Base Costs consultation in December 2021, we were anticipating more detail on how a more systematic data led approach would be used to set PCLs and defining 'what base buys'. We are disappointed that Ofwat has not expanded upon this and are concerned that the proposal in the draft methodology of "*reviewing the levels of performance expected to be delivered by base expenditure by companies across common performance commitments in the round*" leaves the setting of PCLs open to a more discretionary approach.

We also note that by limiting uncertainty mechanisms Ofwat is effectively adding to the downside risk on companies where new obligations appear within the price review period (see for example the current obligations of storm overflows and nutrient neutrality). Ofwat is proposing to introduce Price Control Deliverables (PCDs) to protect customers from forecast obligations that do not actualise which we support. While we recognise the challenge of the current cost of living crisis, in the same vein we would ask Ofwat to reconsider its approach to uncertainty mechanisms for obligations that do arise or have the potential to significantly change during the price review period. Ofwat's approach is in stark contrast to Ofgem and further adds to the underlying additional risks that companies will be taking on.

These asymmetric risks, unless addressed, will need to be reflected in base returns and the cost of equity to maintain the investor confidence that underpins the sector's ability to deliver for customers.

Turning more explicitly to risk and return we are concerned that Ofwat's proposals lack consistency, a key factor in ensuring companies can raise long term finance for new investments, which appears to result in a reduced allowed return for increased risks and a weakening of the financeability assessment. We have provided further detail within Annex 3 to this letter that also incorporates several expert reports on key aspects in determining the allowed return for the notional company.

We are extremely disappointed to see that Ofwat has not maintained the CMA's credible position of the primary role of the Weighted Average Cost of Capital (WACC) in ensuring the notionally efficient company is financeable. If there is to be a change from the most recent regulatory determination for water companies, then it is essential there is substantive evidence to support this change. However, there is a lack of compelling evidence presented by Ofwat within the draft methodology and we believe this undermines the integrity of the proposed changes.

We draw particular attention to the justification for possible changes to the notional capital structure and the unchanged target rating for the notional company when considering the proposed licence changes. In combination, these changes appear designed to solve financeability issues through a focus on boosting hypothetical cashflows to fit ratings criteria.

It is noted that Ofwat believes the determination of notional gearing is purely a regulatory judgement that considers the balance of risk and investment needs. However, there is a lack of reliable analysis to support any reduction of notional gearing below the current 60% and we expect this to be presented if a reduction is proposed in the final methodology.

We continue to believe strongly that financeability is a rounded assessment of all the key aspects of a price review. This should include stress testing of the notional company in line with sensitivities considered for companies' actual financial resilience, which we recommend is adopted by Ofwat as part of its final methodology.

Concluding points

We welcome many of the steps taken by Ofwat but remain concerned that the PR24 process does not create the mechanisms and incentives needed for the industry to respond to the pressing challenges facing our customers, communities, and the environment.

We look forward to engaging constructively with Ofwat in the coming months to ensure that the final PR24 methodology enables companies to successfully address the long term challenges facing the sector and delivers positive outcomes for all.

Yours faithfully,

[redacted]

[redacted]

Head of Regulation
Yorkshire Water
[redacted]

Annex 1: Additional detail: Outcomes for customers

Within this annex, we have outlined further detail in response to the following consultation questions:

- **5.1** 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?
- **5.4** Do you agree with our proposed approach to the measures of experience performance commitments, including to increase the size of C MeX?
- **A6.1** Do you have further views on whether the proposals laid out for C MeX are appropriate?
- **A6.2** Do you agree that C MeX needs to adapt to provide better service to vulnerable and worse served customers?
- **A6.5** Do you agree with our proposed definition for the biodiversity performance commitment?
- **A6.6** 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?
- **A6.8** 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?

Question 5.1 - 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 focus on long term outcomes through the proposed package of common performance commitments (PCs). We are however concerned that the approach proposed in the draft methodology does not take account of the interactions of the three building blocks of outcomes, cost assessment and risk and return. We acknowledge that Ofwat has proposed the assessment of business plan ambitions based on "*stretching but achievable levels of service at an efficient cost to customers*". However, in setting what constitutes stretch for each company, Ofwat also needs to consider the performance commitment level (PCL) targets in the context of each company's asset base, historic targets, spends and enhancement allowances.

The paragraphs below set out details for consideration relating to specific PCs that have not been covered by the remaining consultation questions.

Regarding water demand, we neither agree nor disagree for either approach proposed. We do however have concerns with regard to business demand data due to current difficulties in forecasting business growth and by association, business demand. We have provided more detail below.

Vulnerability and affordability: Affordability is deemed a clear priority for the price review but there are no specific performance commitments related to affordability or financial support. In addition, there is no clear indication in the Draft Methodology documents as to what the proposed 'customer focused' licence conditions will look like, although we appreciate and support the co creation proposed for Autumn 2022. We would like the opportunity to contribute and participate in this co creation approach and wish that Ofwat includes all companies in the group.

Serious pollution incidents: Ofwat propose that water only companies are excluded from this measure. We would therefore like to see the serious pollution incidents PC only cover the wastewater pollution incidents of WaSCs.

We are however more concerned about the inclusion of this measure as a PC, as companies are already regulated and incentivised in this area. Companies are held to account under the Environment Agency's (EA) processes and legal powers and penalised for serious pollution incidents. Thus the 'underperformance only penalty' applied to a serious pollution incidents PC by Ofwat is a duplication of this. We would welcome the removal of this PC from PR24.

Customer contacts about water quality: The proposed customer contact classification will be based on the DWI Information Letter 1/2006 and this is consistent with the Yorkshire Water's PR19 bespoke PC on drinking water contacts. We would like to get clarification from Ofwat that contacts made through other means (e.g., social media, which customers are increasingly making use of) are excluded.

Ofwat is proposing that this PC has a common performance commitment level (PCL) funded through base expenditure. We would like Ofwat to consider that this PC may require company specific performance adjustments due to differences in water company raw water supplies and historical expenditure.

Extreme events: While we recognise that Ofwat is under increasing pressure to hold companies to account for performance, the proposed blanket removal of all extreme event exclusions will result in companies taking on open ended liabilities fully exposed to events that are driven by extreme weather or other factors outside of management control.

We are concerned about the potential removal of the exclusion relating to the Civil Contingencies Act 2014, as part of the proposed common water supply interruptions PC and would strongly support the continued inclusion of this reference, or a similar alternative. This would allow companies to apply for an intervention in cases where proactive and reactive actions, implemented to minimise detrimental customer impact, can be demonstrated.

We part of an ongoing project, alongside other companies, exploring approaches to ensure that the risks associated with extreme weather are shared fairly between companies and customers.

Storm overflows: We support the need to rapidly improve storm overflows and the proposals for a common PC to reduce the impact of storm overflows. In our response to the Governments consultation on Strom Overflow Reduction Plan, we state that it is more appropriate for storm overflow targets to be focused on outcomes, rather than outputs. This is so investment can be focused in areas of most benefit to the environment and public health, and not simply a focus on spill limits.

We remain concerned that the approach proposed continues to drive companies to use carbon intensive, traditional solutions, rather than incentivising catchment scale interventions and green blue solutions delivered in partnership with others. Such partnerships will likely result in multifaceted and far reaching benefits across catchments. An agile partnership approach is needed for companies to maximise partnership opportunities. We ask that Ofwat reconsiders its proposal in the draft methodology to benchmark third party contributions and instead ringfence programmes, with appropriate governance arrangements, to allow companies to draw on this over the AMP in response to opportunities presented.

A multi agency approach is a critical component to delivering storm overflow reduction. As such, supporting legislation and government policy changes will be needed to enable the delivery of these targets.

We remain concerned about regional differences and the substantial scale of investment required across Yorkshire compared to the national average. This will create a significantly greater bill impact for Yorkshire customers at a time of rising concern around cost of living.

Water demand: Regarding Ofwat's the proposals for the water demand PC, we consider either approach of total demand measurement, or of the individual components, acceptable. The data implications of a combined or separate metric are acceptable as these details are currently required part of the WRMP annual review, reported to the EA. However, there is an issue with data on business demand. This is due to current difficulties in forecasting business growth and by association, business demand.

In terms of setting targets on a single or combined water demand measure, we support ensuring consistency with our WRMP24 which will be submitted to Defra in early October. This aims to avoid the mis alignment of targets, leakage calculations and the basis of the measure (i.e., a 3 year rolling average) between the WRMP19 and the PR19 business plan submission.

We have some concerns about the proposed business demand measure; the measure of business demand in aggregate but with the exclusion of very large business customers, e.g., >50ML per annum.

Specifically:

- We have 182 very large business customers who use 25% of total business consumption. By excluding these customers from the measure Ofwat will limit our ability to reduce demand.
- The measure needs to consider new connections, gap sites and illegal connections. Companies should not be penalised for overall business demand if this is due new connections and gap sites. We may see new business connections grow in the future as result of changes outside of our control, such as part of government levelling up policy, or general economic growth. As such, any incentive should consider the potential for growth or contraction of customer numbers.

We recommend an industry workshop to consider the design of a business demand measure, considering industry insight.

The business demand outcome does not consider other outcomes such as the impact on the non household retail market, adverse impacts on retailer turnover and margins. We believe Ofwat should consider the consequences of proposed business demand incentives on the non household retail market and could do this in workshops with wholesalers, retailers and MOSL.

For non household targets, we also believe that the challenge of demand reduction should not fall solely on wholesalers. The market itself is not providing enough of an incentive for water efficiency as business customers have a low willingness to pay, backed up by independent research from Economic Insight[2]. We therefore agree that there should be some incentives for wholesalers to provide stimulus to retailers in this area.

Question 5.4 Do you agree with our proposed approach to the measures of experience performance commitments, including to increase the size of C-MeX?

Question A6.1 - Do you have further views on whether the proposals laid out for C-MeX are appropriate?

Question A6.2 - Do you agree that C-MeX needs to adapt to provide better service to vulnerable and worse served customers?

We support the intention to increase the incentive rate as this will increase company focus. However:

- We need clarity of the ODI rates in the final methodology to ensure a complete view of risk and reward across the PCs is achieved and accounted for within the plan.

[2] https://www.economic-insight.com/2022/06/14/increasing-water-efficiency-in-the-nhh-water-retail-market/

- We disagree with Ofwat's position on sample sizes. We believe that the variance in total contact volumes between companies results in a lack of proportionality to give equal confidence in the comparability of the results. For instance, in 2020 21, annual samples files varied from 19,518 contacts (Portsmouth Water) to 908,912 contacts (Thames Water)[3] which means that for Portsmouth Water the C MeX sample represented 4.1% of their total contact sample, whereas for Thames Water it was 0.09%. Samples sizes should be proportionate to contact volumes. Therefore, we believe that any increase in the level of potential penalty should be accompanied by changes to sample sizes to improve the comparability of the survey results.
- We would welcome the approaches taken with UKCSI to be incorporated into C Mex. We feel the UKCSI provides a robust and reliable benchmark of good customer experience that covers a broad range of metrics. A score based only on a single question about 'service satisfaction' would potentially exclude other important elements of good customer experience such as how customers feel about the company in terms of their customer ethos, complaints handling and ethics for example.
- As the customer experience survey results show a tendency towards water quality responses from customers, we are concerned that the question asked to customers is not optimally phrased. We suggest changing the questions to 'which company provides water and sewerage services to you home?' And then 'taking everything into account, how satisfied are you with the water and sewerage services provided by x?'

In addition, we would like Ofwat to consider the following builds:

Check and challenge: we would welcome more transparency around the survey, not less. Anecdotally, we have heard that some companies have many challenges accepted and others very few. Greater transparency and better quality surveying will achieve more consistency between companies and thus greater confidence. If companies are challenging regularly, this suggests the survey is not working, so instead of removing the challenge process we should be reviewing the survey. This is especially important if the incentives rates are increased.

Number of contact channels: We do not consider the issue to be about the number of channels, but the speed and quality of the interaction. More channels could dilute the focus of existing channels and increase the risk of poor service through increasing complexity of communication methods. Furthermore, if customers are dissatisfied with the channels available to them, this will be reflected in the C MeX score itself. We would appreciate Ofwat presenting the evidence that customers would prefer more communication channels. We would suggest removing the number of channels criteria completely as companies should deliver services to meet the needs of their customers, which will be reflected in the survey outcome.

[3] https://www.ofwat.gov.uk/wp-content/uploads/2021/10/2020-21-C-MeX-D-MeX-Final-Report.pdf

Vulnerable customers: The intent of C MeX is to ensure all customers get the best service every day. As such, it should remain equally representative of all customers. Customers who are dissatisfied with the ability of the company to meet their specific needs will respond to this effect in their survey response, so it is not necessary to apply additional importance on any particular need. All customers' needs are individual to them so it should not be for the survey design to determine which needs require greater emphasis.

We are concerned that Ofwat's proposal for the customer focused licence condition would become duplicated with a specific vulnerable customer focus in C MeX. This duplication would be confusing to customers.

Question A6.5 - Do you agree with our proposed definition for the biodiversity performance commitment?

We agree in principle with the need for a biodiversity performance commitment and welcome its inclusion in PR24. We believe however, there are certain elements of the performance commitment that will require significant investment with no meaningful outcomes for biodiversity.

Firstly, requiring a water company to survey its entire land holding using the biodiversity metric on a 4 yearly basis is disproportionate and will penalise companies with significant landholdings. The metric is intended for use under certain scenarios focused on developments requiring planning permission and is not designed for use at scale. We suggest the allowance of remote sensing data and reasonable, transparent assumptions on habitat type and condition be used.

The proposed definition is around an average increase per ha of biodiversity units. Whilst encouraging comparability, it must be recognised that due to the process used to score habitat quality, this will result in markedly different average rates per company that may prevent comparison. For example, thousands of ha of blanket bog which make up much of Yorkshire Water's landholding would already have a good status thereby lowering the average of any increase. The companies baseline position should therefore take into consideration for any performance commitment levels set.

We recognise that biodiversity is important regardless of site size, however we feel that introducing a minimum site size both reduces costs but more importantly, focuses on the Lawton principles of habitat conservation. We would note it often takes similar logistical time to set up a site visit and risk assessment for a 20 ha reservoir site as to a 5 m2 kiosk compound with the latter having practically no biodiversity unit value. Even the administrative burden of logging and storing information about the impacts of the many hundreds of small scale pipe repair jobs that occur every week could lead to the generation of an expensive paper trail with no more than superficial benefits to biodiversity. It also needs to be acknowledged that undertaking this activity should be funded.

Biodiversity Net Gain as a process has been explicitly excluded by the Government from development projects that can proceed through permitted development rights. We hold these rights for a sub set of our construction work, largely due to the speed by which these take place. We are concerned that the delay required to undertake in season surveys would compromise the rationale for why these rights have been granted and impact on wider customer outcomes.

We believe that it would prove costly for customers for these surveys to be undertaken by ‘an independent appropriately qualified person’ and where these need to be done in person, we would propose they are undertaken by water company staff but with independent assurance through the APR process. Further to reducing costs this will help improve outcomes by retaining in house knowledge about habitat conditions and required actions. We also believe that the definition needs to allow for a transparent methodology to translate between different editions of the Natural England biodiversity metric given much mapping has already taken place using 3.1 (which is proposed in the definition) but that a version 4 is due to be released shortly which companies will be obliged to use for new developments under the Town and Country Planning Act.

We feel strongly that there should be an improved definition of what is included within the scope of the PC, particularly ‘other land where habitat is improved in the process of a water company carrying out its functions’. As examples from the present price review period, Yorkshire Water have worked with regional Wildlife Trusts to deliver direct off site nature based solutions with biodiversity benefits (for example, re meandering chalk streams) and also to deliver ‘pure’ biodiversity focused projects under our NERC Act duties (for example habitat improvement works for willow tit along the Dearne Valley, where we have operational impacts and sites, but not on our land). We would assume these sorts of projects reflect the desired outcomes of this commitment but are worried they would be excluded by the current definition.

We are concerned that the higher proportion of land held by Yorkshire Water will have a disproportionate impact on performance. For example, much of the land owned is leased on long term tenancies, where we have little to no control over land use and activities. We would ask Ofwat to consider how performance levels are set so that companies are set targets based on a comparative basis of land within companies’ control.

We are concerned that the present definition will penalise short to medium term activity that may prevent long term actions from taking place. We request further clarification around how companies can claim future potential benefits. For example, under the metric it is reasonable to assume that tree planning will lead to a decrease in unit value for decades as a moderate condition, likely grassland habitat, is replaced by a poor condition woodland that may take thirty years to reach good status. In its designed for use, the metric accounts for this well, but by using the metric out of its design envelope and simply reapplying 4 year baselines, companies would be unlikely to balance the reward and penalty for at least twenty years.

We are also concerned that the metric is being used as an absolute and predictable method for measuring biodiversity as opposed to an approximation for measuring benefits of development schemes. For example, under the metric it is impossible to score good condition for ponds if the pond does not have macrophytes (excluding duckweeds) covering 50% of the pond that is less than 3 m deep, and also impossible to score good condition if the pond is within 10 m of an artificial structure. The former is detail of a precision that could only be gained through site surveys, not through forecasting the potential activity of unknown impacts 8 years distant, the latter something it would unlikely be in a water company's power to change thereby not recognising any ecological outcomes in the pond. We believe that forecasting against this commitment is going to prove inaccurate under the present definition. We strongly urge Ofwat to refer the Technical Supplement to Biodiversity Metric 3.1. This details the rationale behind design of the metric and the impracticalities around forecasting habitat condition on a site with an unknown habitat class where an unknown activity may take place in 8 years' time.

We would also welcome clarity on the role of the price control deliverable within this commitment and expectations on how this will be forecast. Ofwat has indicated that this will largely be against WINEP commitments which we believe justified if this is focused on biodiversity driven commitments. However, forecasting issues will result if commitments from other drivers are included within the PC. For example, it would be inaccurate and wrong to assume we know the route and therefore habitat baseline of a pipeline that may need to be built in 2029.

Question A6.6 - Do you agree with our proposal to have separate operational greenhouse gas emissions performance commitments for water and wastewater, which are based on a normalised measure?

We are supportive of a common performance commitment for operational carbon, using a market based approach. However, we believe this should be a single commitment based on percentage reduction from a 2019/20 base year, combined for water and wastewater. The commitment should not be normalised.

We have outlined the detail to this response, as well as other points for consideration in relation to this PC.

Split out of water and wastewater into separate PCs: We do not agree with the proposal to split out operational carbon from water and wastewater into separate PCs. Whilst we acknowledge that it may encourage ownership of emissions within the water and wastewater operational teams, it would introduce complexity, admin burden and create even greater challenges on the introduction of a common reduction level.

Issues with a common reduction level would arise because the key reduction opportunity within water treatment is energy efficiency. From a market based viewpoint (which we support and discuss below) there will be two distinct emission profiles for water treatment; those companies who source green energy and those who do not. For companies who do not yet source green energy, their short term reduction potential may be greater than 50%; but for those who already source green energy their key emission reduction opportunities will be more limited. For example, reductions arising from fleet transition and fuel switching, followed by process emissions   a more challenging to abate source, requiring greater investment.

A common reduction level across these two distinct profiles would either be too low (and not deliver the reduction needed) or unfairly penalise companies who already source green energy. This issue does not go away with a combined PC, but the impact would be significantly reduced.

To eliminate this issue, maintain reduction ambition and avoid penalising companies who have already made good progress, any common reduction level should:

1. Have the sourcing of green energy embedded within it, i.e., the common reduction level be applied to 'market based emissions excluding grid energy' and exclude a transition to green energy as permissible towards achievement of the target.
2. Provide access to incentives only if companies have transitioned to green energy. This green energy should include not only scope 2 emissions, but also scope 1 emissions (green gas replacing natural gas) and scope 3 emissions (transmission and distribution losses relating to grid electricity).
3. Be set against a baseline year of 2019/20. This ensures that key reduction initiatives between now and 2025 form part of the 2025 30 price review incentive rather than being 'lost' in the reset of a new AMP8 baseline.

Another reason not to split out water and wastewater emissions into the two PCs proposed, is that there would be a proportion of emissions which do not relate directly to either of the two PCs, such as head office building costs. This suggests that these emissions would either have to be allocated to water and wastewater on some prescribed basis; or omitted. This would introduce unnecessary inaccuracies that a single common performance commitment would avoid.

Combining into one PC would not reduce abatement potential nor necessarily mean losing any detail of the underlying datasets. Progress in emissions reduction for each of water and wastewater operations could still be reported transparently in the supporting APR tables, presenting water and wastewater emissions separately under both the location and market based approaches.

Normalisation: The draft methodology proposes, an option to use intensity measures (e.g., distribution input or volume of wastewater treated) to normalise the performance of companies. Measures of intensity are well accepted ways to compare performance over time within a single company, however these need to be used with care when trying to compare between different companies. We are not in favour of the proposed approach because it would introduce factors outside of the control of water companies (the weather, population growth, nature of industrial uses etc.) and therefore impact comparability. It would also potentially mask whether absolute emission reductions have been achieved

The path to net zero: The PR24 draft methodology states that a primary reason to have a common operational carbon PC is to, "*incentivise companies to work towards the final and interim targets for net zero emissions of the UK and Welsh governments*". These interim targets are a 78% reduction by 2035 for the UK and 89% by 2040 for Wales. A common reduction level would therefore need to put companies on a suitably ambitious glide path to both these targets (given the reduction level is common). Importantly, these government targets address all scopes.

In 2019/20 we joined other companies in the UK water sector by making the public commitment to deliver net zero carbon emissions by 2030. This was communicated in the Water UK Public Interest Commitment[4]. The working interpretation of this commitment is that we will achieve net zero operational emissions, as defined by the scope currently set out in the Carbon Accounting Workbook (CAW). We believe that this presents a suitably ambitious glide path to the government targets set out above, allowing us to focus in 2030 to 2050 on eliminating the remaining emissions necessary to achieve the interim and final government targets for 'full' net zero set out above.

The draft methodology also states, "*companies are expected to be clear if reductions in company emissions are delivering net zero in line with national government targets.*" We agree that this is a sensible approach. We therefore believe that a common reduction commitment for the 2025 30 period should align with the net zero operational emissions by 2030 target.

Emissions' boundaries: Measurement of emissions for the PC is currently using the prescribed CAW. This helps to ensure companies report their emissions on a basis consistent with the rest of the sector. However, the scope of emissions included within the CAW is inconsistent with global reporting standards and hinders comparability with companies in other sectors. It is therefore not a useful methodology to measure performance towards government targets. This makes it more complex for our stakeholders (in particular, our customers) to understand our emissions performance.

We believe therefore that there is a case for moving the scope of emissions measured and reported to be more closely aligned with global standards such as the Greenhouse Gas (GHG) Protocol. However, how we do this as a sector, over time, will need to be thought through carefully to avoid undermining the integrity and achievability of the PC.

As set out above, the CAW currently defines the scope of operational carbon for achievement of net zero operational emissions by 2030. This is a commitment that was made in good faith, by the water companies involved, based on the information we had available at the time. Whilst recognising the limitations in the CAW methodology and also a number of unforeseen factors that will impact our emissions over time (see policy pressures and process emissions below), we are keen to uphold our commitment and maintain our focus on

[4] https://www.water.org.uk/wp-content/uploads/2019/04/Public-Interest-Commitment.pdf

achievement of this target. It is useful, therefore, to maintain the focus of the PC and associated incentives on this same scope.

However, in addition to the emissions measured within the scope of the PC, we believe that wider APR reporting could and should be aligned more closely to GHG Protocol. For example:

- Organisational boundaries should be consistently applied. Given the nature of sector, with an economic regulator acting on behalf of customers, we believe this should be the financial control method.
- Scope 1 emissions should include emissions from land owned by the water company.
- Scope 3 emissions should be structured and reported in line with the GHG Protocol Scope 3 Standard, with the defined 15 categories of emissions and companies being encouraged to estimate these where they can.

The CAW could still be the platform for collating activity data and/or emissions, which would allow a more holistic view of a company's emissions by both companies and Ofwat alike, but only the current subset of these would feed into the PC.

Similarly, we note that the draft methodology currently excludes a PC for embedded emissions but that Ofwat expects progress to be made in the development of a suitable metric during the 2025 30 period. In developing this metric, and to align with the above, we believe the structure and guidance of the GHG Protocol Scope 3 Standard should be used by the sector to achieve this. This would include using the term 'capital goods' to replace the current term 'embedded emissions'. Commencing use of this terminology now, in the PR24 methodology, would help to align thinking within the sector with recognised global standards, noting that a focus on this category of emissions will become increasingly important between 2030 and 2050.

Updates to the CAW: "*We consider that automatic annual updates of the definition to the latest version of the CAW methodology present a risk of future versions containing significant changes in methodology that could impact the integrity of the performance commitment.*" For our views on annual updates to the CAW, please see our comments submitted on 9 March 2022 as part of the "*Response to consultation on changes to the CAW version reference in 2020 25*".

In this we set out how we believe the integrity of the PC could be maintained, despite an annual update to the CAW and how performance could continue to be presented to stakeholders in a meaningful way through use of an emissions bridge.

Offsets: The draft methodology states that, "*we expect companies to prioritise the elimination and reduction of greenhouse gas emissions before the use of offsets*" and that some companies "*suggested including the option to offset emissions in order to deliver reductions in the near term, as they argued that time is needed for some approaches such as nature based solutions to deliver reductions in greenhouse gas emissions*". We agree that companies should prioritise the elimination and reduction of greenhouse gas emissions before the use of offsets.

However, we believe that where companies are investing, on their own land, in land management schemes such as woodland creation and peatland restoration through recognised schemes such as the Woodland Code and Peatland Code, then these ‘insets’ should be recognised within the PC from the point where the benefit can be reliably measured. Care should be taken to ensure that ‘double counting’ is avoided should land emissions be brought into scope 1 of the CAW (as suggested above).

Further guidance on the use of offsets, and also greater support for the generation of insets, would be valuable to include in the final methodology.

Policy pressures: There are various regulatory pressures being placed on the sector e.g., phosphorous removal as part of WINEP, storm overflow prevention, and constraints on land management. These place varying pressures including increased use of energy, increased use of chemicals; and generation, processing, and transportation of sludge, which place significant upward pressure on our carbon emissions, with the impact expected from 2025 onwards. These emissions are additional to those measured in our baseline and unless accounted for separately or considered in target setting, could make achieving target reductions during the 2025 2030 period challenging. We would welcome the opportunity to engage with Ofwat to build a common understanding of the scale of additional emissions anticipated and how these should be addressed from a carbon accounting and target setting perspective.

Process emissions: The draft methodology states that, “*most of the scope in the short term is for the abatement of process emissions of nitrous oxide and methane*”. This is inconsistent with our experience, where process emissions present us with the largest decarbonisation challenge in the near term. Process emissions make up around 70% of our market based emissions but given the nature of the process they arise from, combined with how they are measured, make them extremely challenging to reduce.

There is also an emerging challenge related to the scale of process emissions reported by the sector. This has been highlighted by a move by Severn Trent towards direct measurement of process emissions. This move recognises that estimations which form assumptions in the current CAW may be understating emissions because they are based on limited historical science. Severn Trent have separately reported emissions for 2021/22 that are 250% higher than calculated using the CAW. Some of our own work also suggests the CAW methodology understates process emissions.

We believe it is important that provisions are made in the final methodology to allow a fair approach to this evolving space. New measurement methodologies could, in practice, be incorporated into the CAW as the science evolves, along with re baselining. However, any interaction with the PC would need to either retain the current estimation approach (for a consistent measurement basis) or recognise that reduction targets will need to be adjusted to give companies time to understand and plan a new reduction approach given the revised measurement basis. As for policy pressures, we would welcome the opportunity to engage with Ofwat to build a common understanding of the scale of additional emissions anticipated and how these should be addressed from a carbon accounting and target setting perspective.

Impact of trading sludge: We have sought to help increase the efficiency of the sector by treating other companies' sludge. In doing so, we have, in effect, been penalised by increased operational emissions. The final methodology will need to ensure that trading sludge and treating other companies' sludge does not penalise recipient companies' performance against the PC.

Question A6.8 - Do you agree we should focus the bathing water performance commitment on the outcome that customers have received and should continue to develop an alternative definition to do this?

We strongly disagree with Ofwat's proposal for creating a new sample based approach rather than focussing on the legislative requirements under the bathing water directive. Funding has historically focused on meeting the classifications set under the Bathing Water Directive, introducing new metrics would lead to a disparity between future assessment of performance and historic investment levels.

Ofwat's shared metrics have been developed based on coastal performance data. To date, there are currently two riverine bathing waters in England. Under the Bathing Water Directive, coastal and inland bathing waters are assessed under different thresholds. We would raise concerns at inland bathing waters being assessed against coastal performance data, however, there is also not a large enough dataset for inland metrics to be developed.

We also believe the different assessment metrics could be confusing to customers. Ofwat's proposed naming for the thresholds are too comparable to those from the bathing water directive. Introducing a new metric also has the potential to impact on the coastal economies with bathing waters being assessed against tighter thresholds, and the potential for lower assessment data being published. As we all move towards feeling the cost of living impacts to a greater extent, introducing a new metric which could have implications for coastal communities could have significant lasting impacts.

Additionally, we believe this could lead to unfair disadvantage for water companies, particularly when looking at abnormal situations. Under an abnormal situation, a sample could be replaced due to a pollution incident. These pollution incidents which may be outside of the water companies control and can be varying in duration. If performance would be assessed in year, a long lasting third party pollution incident could have a significant impact on the ODI performance.

The draft methodology refers to developing a new performance commitment metric based on the outcome that the customers receive rather than using the Bathing Water Directive classification methodology. We have numerous concerns in relation to this approach:

- Customer Experience: we believe introducing a new 'sample based approach' by which to measure bathing water quality would be confusing for customers. The bathing water directive is used and commonly signed across Europe for beach users, this information is also readily available online. By introducing a new metric which does not align to the legislative requirements, customers could be faced with conflicting information creating confusion.
- Public health and data led approach: the European Bathing Water Directive is based World Health Organisation research and the likelihood of bathing water users becoming unwell. Any new approach would need to be scientifically founded, which is likely to take a significant amount of time and research given the public health ramifications. The thresholds for inland and coastal waters also differ, with limited data available on inland environments in the UK, particularly rivers. It would therefore be a challenge to develop a performance metric based on such limited dataset.
- Community impacts: using a different method of awarding a classification could result in a beach receiving a lower classification than that award under Directive methodology. This perceived reduction in bathing water quality could lead to a detrimental impact on the local economies who predominantly rely on tourism.
- Discounting and public information: discounting is based on Pollution Risk Forecasting or PRF by the Environment Agency and ensures that warnings are displayed to members of the public. These models are reviewed annually, and forecasting is removed from beaches where there is not a good level of explained variance in the model. This results in models which forecast more accurately being available for the public. As such these forecasts tend to be in periods of significant storm events where bathing numbers are low due to the safety risks of entering water bodies under these conditions. As such we do not believe it would be reflective of a reduced experience by customers.
- Abnormal Situation: samples can also be removed through the abnormal situation process. This process can refer to any pollution which has the potential to impact on bathing water quality, as such it does not only include pollutions from water company assets. Third party pollutions and naturally occurring incidents such as a dead whale or large scale agricultural pollution, which water companies have no control over are also addressed through this process. An abnormal situation is a type of pollution not likely to occur more than once in four years on average, as such impact to customers actual experience would be low. Missed sample results are replaced by additional samples on other dates during the season as to ensure the season remains representative. Not removing samples for an abnormal situation has the opportunity to impact upon the classifications across a 4 year period. Additionally, water companies are already penalised for pollution incidents from their assets through our Pollution Reporting ODI's and where appropriate through legal action by the EA and subsequent fining, which both take account of amenity value of the receiving watercourse.
- The draft methodology states that it wants to hold water companies to account for past and future investment. We believe that it is fully possible to do so but without it being necessary to hold water companies to

account for third party impacts or abnormal situations that are outside of water companies' control.

We support a common performance commitment for bathing waters across all water companies. However, this is on the basis of targets being determined based on historic investment into bathing water quality.

We strongly support an approach to look at improvements across all bathing water classifications rather than a sole focus on targeting 'Excellent'. As such we strongly support using the 'weighted classification based approach' based upon the classifications issued by Defra under the bathing water Directive. This supports water companies to focus on improving all bathing waters.

We support the approach to exclude bathing waters where there is no potential water quality impact by the water company. Although we seek clarification on the evidence required to provide this or how a determination is made as to which assets do or do not impact a bathing water. The methodology refers to isolated lakes, however, there are additional scenarios that would need to be accounted, for example coastal waters with no water company assets which are more complex than isolated waterbodies.

We support the approach to use the previous year's classification if a bathing water cannot be classified. We also support the approach to remove any de designated bathing waters from an average score.

Annex 2: Cost assessment detailed responses

We have provided further detail to accompany question responses relating to cost assessment. Within this annex, we have presented further information relating to the following of Ofwat's consultation questions.

Question 6.1 – Do you agree with our proposed approach to setting efficient expenditure allowances at PR24?

We recognise the difficulty of developing a cost assessment approach, that considers the vast complexity of the water industry, and forecasts efficient costs whilst encouraging companies to reveal future efficiencies. We welcome the process proposed by Ofwat for cost model development and consultation between September 2022 and Spring 2023 and look forward to engaging with this process. There are elements of the approach that we agree with and elements where we still have concerns following on from our Assessing Base Costs at PR24 response in February.

Principles: We broadly support Ofwat's principles of cost assessment, but it is still not clear what would define a cost allowance as 'stretching but achievable'.

On the principle of exogeneity, whilst we understand and agree with Ofwat's concerns about endogenous variables, we suggest they should not be dismissed completely from cost assessment; they may prove to be genuine drivers of cost which must be considered through some means as other economic regulators regularly do.

Approach to Cost Modelling: The form, aggregation, and scope of the cost models, as well as the variables being used, are key inputs to the price review process. We believe there is time and scope to continue to engage with the industry and we encouraged to see that Ofwat intends to consult further on the development of its approach and final form, even if the outcome will be very late in the business planning cycle.

We caution against making firm decisions on cost model form, aggregation, and variables without testing against PR24 datasets. If more robust models of a different form can be developed, then these should be used. While the CMA review at PR19 did not find fault in Ofwat's approach for cost modelling, a bigger and richer dataset available at PR24 may mean that other models maybe better at describing costs.

Ofwat has recognised this by exploring new variables such as STW complexity, but this may also be true for other variables and is not just limited to the cost driver specification but to other areas such as aggregation as well.

For example, Ofwat assessed that it was inappropriate to water resources models at PR19 on the basis that

i. only a few cost drivers could be included in the model for the model to produce ‘sensible’ coefficients; and
ii. there was an infeasibly wide range of efficiency scores.

These were empirical observations based on the data at hand and, as such, may change once new or better data becomes available.

Modelled allowances were highly sensitive to using the latest datasets available. Given the influence of input datasets on the cost modelling outcomes we encourage Ofwat to take this fully into account.

We also consider that there is scope to investigate modelling techniques that reflect the significant pressures that the industry is currently experiencing chemicals, raw materials, labour, and energy that may persist into the next period. This is particularly important for the Retail price control where there is no CPIH indexation or existing protection against input price pressures if they significantly vary from the plan.

Catch-up Efficiency: Ofwat does not provide any details regarding the type of evidence that it will consider when setting ‘a stretching’ efficiency benchmark. It is important that the benchmark is determined by an objective assessment of the quality of the econometric models (which, in turn, should be based on quantitative measures of modelling uncertainty) rather than on a desire to set an arbitrarily stringent efficiency challenge.

Frontier Shift and Real Price Effects: We note that very little has been shared at this stage on Ofwat’s approach to assessing the frontier shift or how it will assess and mitigate against any input price pressures. This are potentially extremely material issues and engagement with the industry on Ofwat’s early thinking on these issues is imperative particularly given the current volatile economic climate.

Cost adjustment Claims: cost adjustment claims. As discussed in Question 6.5 it would be useful for companies to have a similar set of guidance for setting out any proposed adjustments to PCLs (performance adjustment claims).

We welcome Ofwat’s recognition that not all CACs might be symmetrical adjustments but still have concerns about how a symmetrical adjustment interacts with the materiality gate.

For example, Company A may identify a relevant driver of cost (X) that falls just short of the materiality threshold and is not submitted as a CAC. But Company B may have a driver (Y) that justifies a claim value above the threshold and is awarded an adjustment. In this example Company A’s allowance may be symmetrically reduced due to Driver Y (which may be less than the materiality threshold) when in fact a botex reduction is not appropriate had Driver X been considered.

We also question Ofwat’s approach to assessing the symmetrical claim for other companies as set out in section A1.3.

Table A.1: symmetrical cost adjustment – illustrative example

Step	Calculation	Company A	Company B	Company C	Company D	Total
(1) Gross cost adjustment claim related to factor X (before deduction of implicit allowance)		£20m	£0m	£0m	£0m	£20m
(2) Scale variable		1,000	2,000	3,000	4,000	10,000
(3) Implicit allowance related to factor X	£20m * (2)/sum(2)	£2.0m	£4.0m	£6.0m	£8.0m	£20m
(4) Symmetrical cost adjustment	(1) – (3)	£18m	-£4m	-£6m	-£8m	£0m

This simplified example assumes that an issue uniquely affects one company. In reality, many claims are likely to affect several companies, which would complicate the calculations. (i.e., line (1) would not be £0m for companies B D)

For some drivers (where there are national datasets available) it could be easy to run some analysis to calculate (1) for each company, but for others (where costs are built bottom up and are company specific) it will be hard for affected companies (or Ofwat) to assess the gross value of the claim for all companies.

Long term Capital Maintenance: Ofwat needs to ensure forward looking and long term approach to asset health recognising there is a need for a step change in the level of asset maintenance and replacement at PR24. We need to ensure that the sector is on a long term sustainable path. The draft methodology currently does not recognise this as an issue and continues to assume that historical expenditure has been sufficient to maintain asset health. We refer to a recent report commissioned by Water UK that sets out clear trends suggesting the need to step up the level of capital maintenance and proposes practical options to achieve this sustainably in the long term[5].

Our comment on areas covered by questions 6.2 6.10 will be included in our responses to those questions.

Question 6.5 - Do you agree with our proposed approach to setting performance commitment levels at PR24?

and

Question 6.6 - Do you agree with our view on what performance commitments should be set using common or company specific performance commitment levels?

We recognise the challenge in setting performance commitment levels for 17 different companies and the complexity and noise in historic datasets which makes it very difficult to accurately set appropriate PCLs. There are clear simplicity and comparative benefits to Ofwat of setting common PCLs.

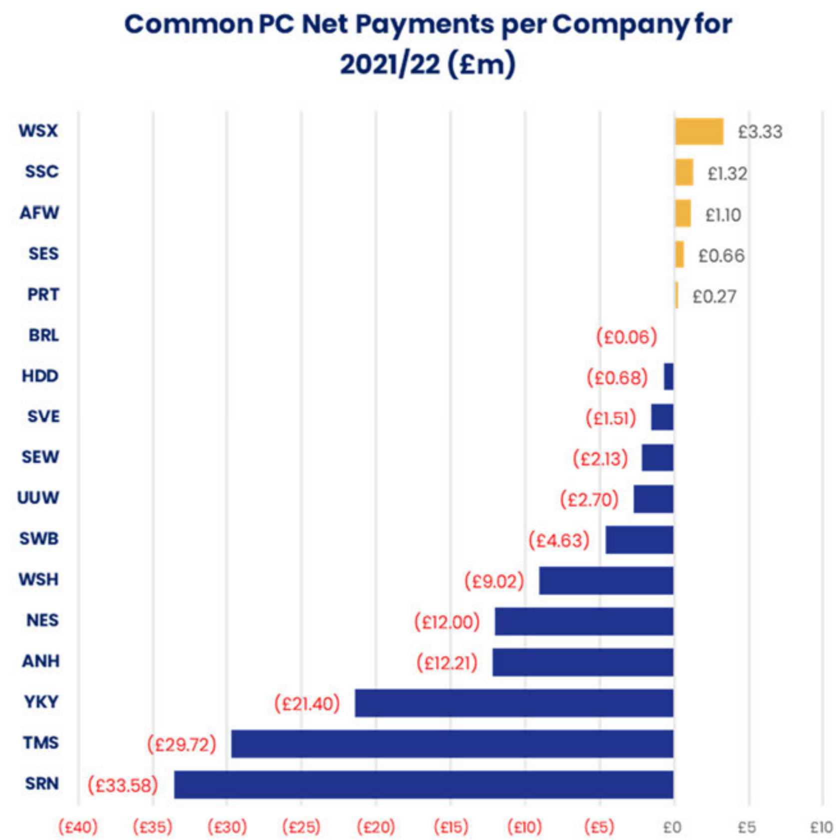
[5] https://www.water.org.uk/publication/options-for-a-sustainable-approach-to-asset-maintenance-and-replacement/

However, it is because of this complexity the range of differences in company asset bases, historic activity and expenditure and the regulatory targets and incentives set in previous periods that we do not see that common PCLs (outside of legal compliance) should be the default. We have been consistent in this view since responding to Ofwat's PR19 Draft Methodology. We note and welcome that Ofwat does recognise that external factors can affect performance targets in some cases.

In that response we raised concerns with the assumption that customers had already funded both upper quartile efficiency and upper quartile service performance across all common PCs and we maintained through our CMA appeal that this was not the case.

In the draft methodology, Ofwat notes *"that 60% of common PCLs were achieved in 2020 21. This suggests that PR19 PCLs were not overly stretching."* We could not replicate this (using the stated data we calculated the pass rate at 52%) and note that this excluded the common PC of PCC which all companies failed.

The recent APR data for 2021 22 shows a similar position in terms of achievement, however just 4 companies received a net reward totalling £6.6m for common PCs with the remaining 13 companies receiving a net penalty totalling £129.6m. This is despite an industry overspend on base allowances. We believe this highlights the extremely stretching nature of the PR19 Common PCLs, incentives, and costs.



As per the Regulatory Accounting Guidance (4.09 13.1) we consider "*base expenditure is to maintain the current level of service to customers*" and not to achieve significant service improvements. We do not consider that service improvement can be sustainably achieved through base costs as currently assessed.

We welcome acknowledgement that historic improvements may not be indicative of the rate of future improvement. However, we maintain the view that the relatively low productivity of the industry highlighted in recent Ofwat analysis is explained by the service improvements during that time which are in themselves productivity improvements where cost allowances have not been correspondingly increased.

If Ofwat assumes that companies can improve productivity at (e.g.) 1% p.a., then it should work out what fraction of that 1% should be allocated to cost reduction and what part should be allocated to service improvements, rather than apply the productivity challenge to both (thereby resulting in a double count). We are part of an industry club project that will shortly outline some options for considering this[6].

Following on from the Setting Base Costs consultation in December we were anticipating more detail on how a more systematic data led approach would be used to set PCLs and defining 'what base buys'. We are disappointed that Ofwat has not expanded upon this and are concerned that the proposal in the draft methodology of 'reviewing the levels of performance expected to be delivered by base expenditure by companies across common performance commitments in the round' leaves the setting of PCLs open to a more discretionary approach.

We agree that it makes sense to include improvements from enhancement expenditure when considering PCL targets.

Any changes to PCLs due to Enhancement spend need to be reflective of other changes to PC mechanisms. For example, the removal or extreme weather exclusions with no additional investment is in itself a service improvement. Resilience enhancement investment should not therefore necessarily impact on PC levels in such cases.

Adjusting PCLs to reflect enhancement gains may have the effect of setting non common PC targets which reduces comparability and will mean levels can no longer be considered to be common in future periods. In acknowledging that enhancement expenditure can impact on relative PC levels between companies this puts the default position that PCLs should be common in question. If enhancement can cause relative targets to change this should be reflected in the baseline levels of service i.e., these should not be common as different companies have received different enhancement allowances historically.

[6] https://www.economic-insight.com/2022/09/01/a-cost-quality-approach-to-productivity-and-pc-marginal-cost-estimates-at-pr24/

Ofwat indicates it *"will consider setting company specific performance commitment levels when performance is materially affected by an exogenous factor not captured in our base cost models and/or differences in historical enhancement expenditure allowances."*

This is effectively a Performance Adjustment Claim[7]. We believe there would be merit in having a similar mechanism to the CAC process to adjust performance. This could be set out in clear steps as per the CAC process in Appendix 9.

We have concerns about the evidential bar required to meet the second part of this. We do not necessarily know the wider performance benefits delivered though other companies' enhancement allowances.

The industry is not incentivised to share the benefits of historical enhancement with each other. Ofwat may be best placed to share what enhancement funding has been applied to each company in the past and how it could have improved service levels relative to others.

Finally, stretching performance must be considered in the round. We believe that looking at each PC individually and setting the target based on the most stretching company in that area risks an unreasonable stretch at the programme level that no individual company could achieve.

Question 6.7 - 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?

Net Zero / Greenhouse gas emissions (GHG): Welcome that Ofwat is considering funding net zero specific enhancement funding and reflecting the climate emergency.

We agree that further operational carbon reductions may be achievable using our base allowances in a more carbon friendly way but note that there is likely to be diminishing returns compared to those GHG carbon emissions already delivered. These diminishing returns will also impact the net zero enhancements and competitive bidding process as set out, with those companies who have been most proactive in reducing emissions historically appearing less efficient with an inherently higher abatement cost per tonne.

We fundamentally disagree with the assumption that a further reduction in operational carbon will be achieved through the standard enhancement scheme investment. Whilst there may be schemes that have net reductions in GHG emissions, this will be significantly outweighed by other schemes that require additional power/chemicals/labour to meet our statutory drivers.

[7] Or that where such externalities are well understood, it would be a company-specific target based on appropriate modelling of the causal relationship

Ofwat "*note that most of the scope in the short term is for the abatement of process emissions of nitrous oxide and methane*", however it is our view that whilst process emissions make up a large proportion of the GHG we want to reduce, they are some of the most difficult and expensive emissions to remove given the existing treatment asset base.

In terms of the overall approach for funding GHG reductions we feel there is a significant amount of detail missing from the proposals to provide a fully considered response.

Cost allocation: We are not clear on the 'Standard Enhancement' v 'Net Zero Enhancement' categorisation. For example, in a case where the 'best value' solution for a Standard Enhancement scheme is not the solution that best helps to achieve the Net Zero target (i.e., the Net Zero solution is more expensive). How should such an activity be included in the response? Should there be an apportionment of costs between the standard enhancement and net zero enhancement lines?

Bidding Framework: We are concerned that the bidding framework will give allowance only to the companies with the lowest abatement costs per tonne. This concern is twofold, firstly it penalises the companies who have been most proactive in reducing emissions historically (and as noted previously, may have a relatively high abatement cost per tonne) but also because of the delays this could cause in addressing climate change, as one of the most pressing issues of our time.

The draft methodology states that "*the learnings from these investments would be shared over the period, allowing all companies to implement these lower cost solutions in future periods*." This delay will significantly slow the sector's transition potential and risks making the sector's commitment to net zero operational emissions (a key part of the efficient glidepath to the government's net zero targets) unachievable.

The IPCC report 2022[8] warned that the world is set to reach the 1.5°C level within the next two decades and that only the most drastic cuts in carbon emissions from now would help prevent an environmental disaster. The impacts of climate change are also causing significant, additional operational and financial burden for the sector (with the named storms, heatwaves and drought of the last year being felt acutely by us).

Net zero enhancement funding needs to be available to all companies. Flexibility in AMP is also needed to allow learnings to be drawn on more quickly, with allocation of funding reflecting the inherent diminishing returns of the difficult to abate emissions, as appropriate.

The bidding framework is unclear, and we would welcome more detailed guidance on this. For example, will the bidding happen as part of the PR24 submissions up front or during the AMP? Will there be a set amount of additional funding available? Will this be part of a centralised allowance (as per the

[8] https://www.ipcc.ch/report/ar6/wg2/

innovation fund) or will the costs be borne by the customers of the companies that propose the lowest bids?

It is not clear how companies will know what net zero schemes to bid for until we know what reduction is required through base, standard and net zero enhancement.

Storm Overflows: We welcome Ofwat's acknowledgement that enhancement expenditure will be needed to meet Storm Overflow obligations and that the national targets may mean that additional funding beyond PR24 WINEP programmes will be needed.

There is little information provided on how PR24 costs will be assessed but cost allowances need to be set reflecting the differences in company asset bases and operating conditions as well as the resulting variations in intervention requirements.

As we set out in our response to the Government's Storm Overflow Discharge Reduction Plan consultation in May, we have some serious concerns about the affordability and benefit associated with the output based spill targets, which will particularly impact on customers in regions that have greater proportions of combined sewers.

The potentially massive investment required in this area needs to be delivered alongside other vital investment in high quality, resilient infrastructure to ensure that water and wastewater services are secure for the future.

Question 6.9 - Do you agree with our proposed approach to encouraging companies to deliver best value through our cost assessment?

We agree that the most beneficial solutions should be efficiently funded and are pleased that Ofwat is considering an issue that we raised throughout the PR19 process.

We understand that common monetary valuation is preferable and simplifies the comparative process for Ofwat but would like opportunity to demonstrate benefits that are not in the Ofwat/EA valuations if appropriate.

For PR19 and the AMP7 business as usual, we have been using our Service Measure and 6 Capitals framework, where the evidence base for the monetised valuation has come from different sources, including triangulated valuation from the PR19 customer 'willingness to pay' study, published literature on ecosystem service benefit and other (e.g. cost of carbon) values and our own evidence on the private cost of failure (i.e. the cost to YW to 'react' to a service failure).

For example, our valuation on leakage reduction is not only focused on customer willingness to pay to reduce leakage but also on the carbon benefit of leakage reduction. We are concerned that overly focusing on using a single source of valuation evidence is prioritising consistency at the expense of greater understanding of impacts and the value of these impacts.

We support the inclusion of other/additional benefit valuation sources if appropriate, similar to the EA's approach to the WINEP CBA where an 'optional parallel benefits assessment' is allowed, and other non monetised information is considered in the decision making (please see the EA's Options Development Guidance document). We also would like to highlight some concern regarding potential inconsistencies in the WINEP benefit assessment with Ofwat's best value assessment. River Water Quality is a benefit metric that is included in the WINEP cost benefit assessment, and the valuation is based on the (regional) NWEBS values. River Water Quality is also a service attribute included in the collaborative ODI rates study therefore it is expected that a separate benefit value on River Water Quality improvements will be available. As we do not yet have visibility of valuation results from the collaborative ODI rates research, we cannot say how different (or similar) the River Water Quality value will be from the NWEBs values used in the WINEP cost benefit assessment. However, if they have an order of magnitude difference, we could end up in a situation where the preferred solution in the WINEP assessment is different to the one selected in the best value assessment.

The case of using a best value assessment to determine which solutions to fund and implement is sensible: if customer preference show that the additional impact(s) of a solution have 'value', then it makes sense to select a solution that delivers the most value. However, we still would like to express concern on the validity of the outputs from the collaborative customer valuation exercise in terms of using them in a cost benefit and best value analysis. The Ofwat ODI Research Peer Review (eftec, 2022) has raised concerns on how little is known about how the approach reveals customer demand to changes in service levels relative to current service levels. Additionally, the approach does not examine and break down customer preferences for long term priorities. This is important as the best value planning focuses on enhancement expenditure that links with long term strategies which cover environmental protection, customer service improvement and operational resilience.

We welcome clarification from Ofwat on the assessment of best value with regards to the timing of investment as the present value and benefit cost ratio calculation will be affected by this assumption, as we feel this is missing from the guidance set out in Appendix 9 Section 6.1.3. We want to understand if the calculation needs to exclude the assumption on when the least cost and the 'best value' solutions are implemented (i.e., what year in AMP8 a solution starts) so that the comparison between them stays like for like.

We understand how Ofwat would use this 'best value' assessment in deep dive approaches as it has done previously. However, we are not yet clear how a best value assessment would be reflected into any econometric cost modelling approaches for Enhancement schemes. For example, how does Ofwat make sure that econometric models produce 'best value' efficient costs as an output rather than using the lowest in AMP cost to assess efficient costs as was the case at PR19.

If Ofwat is using historic data in enhancement cost models, these costs may not have been 'best value' at the time in some cases previous models may have only allowed sufficient costs to implement the lowest cost in AMP solutions. This may lead to underassessment of best value solutions in the resulting models.

Would also like further guidance on how Carbon Costs are included in the 'best value' calculation. More specifically, is the cost of carbon of an intervention considered a 'dis benefit' (a negative benefit) or part of the whole life cost calculation. This makes a difference to the cost benefit calculation and its result.

Please note, in the WINEP CBA approach, the EA has advised that capital and operational carbon costs are included as a 'dis benefit' (i.e., subtracted from the benefits rather than part of the whole life cost).

Partnership working: We are pleased that Ofwat has taken some steps to promote partnership working, however we are however concerned that Ofwat's view of partnerships is too narrow and, most importantly, fails to recognise and acknowledge the need for flexibility and innovation which are crucial for successful partnership working. We are also concerned that the current suggestions for benchmarking places too much risk on water companies for issues outside their control, such as the lack of visibility of partnership funding options ahead of time which in our experience, require agility.

Question 6.10 - 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 are pleased that Ofwat is recognising this issue with respect to Nature Based Solutions (NBS) but believe it is wider than NBS and is a concern for all Enhancement schemes with significant costs beyond the 5yr period that are not reflected in base variables.

Ofwat sets out the options currently available to companies which we comment on individually below:

- **Absorb the additional opex in the period before they are reflected in the base models:** As companies are incentivised not to overspend their allowances (through cost sharing), it is likely that this absorption is in the form of carrying additional risk rather than overspend and hence will not be reflected in future base models.
- **Resubmit as enhancement in the next period:** We do not see how the Regulatory Accounting Guidance allows for this given there is no new driver or improved level of service. We would welcome further information on this option.
- **Submit a cost adjustment claim for an enhancement to the base allowance:** The materiality threshold associated with CACs means

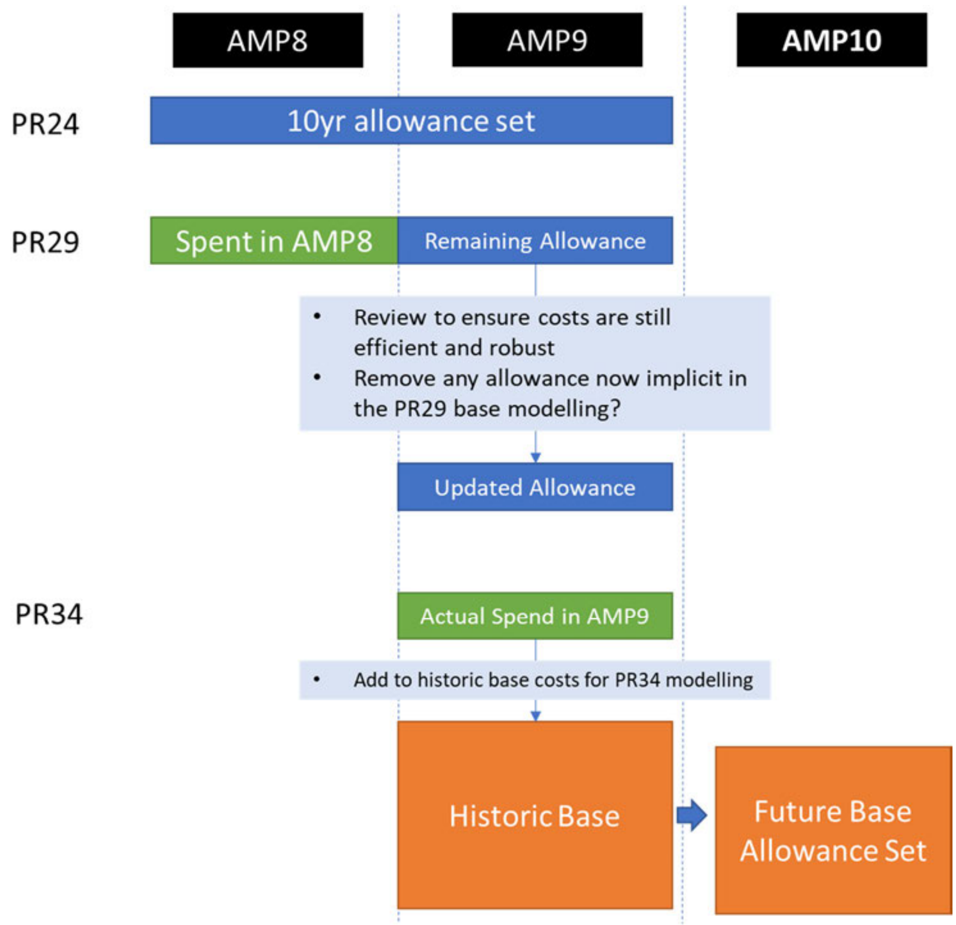
that any individual driver may struggle to meet the threshold whereas the cumulative effect across drivers can be a material cost gap.

A proposed solution

We are not convinced that the addition to the RCV is the right response   this is because the amount of complexity that would need to be introduced to mitigate the challenges that Ofwat itself sets out would be large. We also have concerns that treating operating costs as capex could lead to an impact on companies' financeability and financial resilience metrics as costs would still be categorised as operating expenditure in companies' actual accounts.

Instead, we think the 10 year allowance option as suggested as an alternative by Ofwat would be much more appropriate.

This 10 year allowance should not be limited to NBS however but is appropriate for any best value enhancement costs that have ongoing investment into the next period which the Botex model variables do not (or only partially) make allowances for.



At the next price review (i.e., PR29) this ongoing cost should be reviewed and challenged to ensure the costs are still efficient and robust. A test would also be applied to see whether any new Botex modelling now includes a variable that makes an allowance for this ongoing cost. If it does, then the 'implicit allowance' in the base modelling would be removed from the ongoing enhancement expenditure. We note that, even under this process, companies may still be disincentivised to engage in OPEX based solutions if there is a risk that a large proportion of it will be disallowed after five years under these mechanisms. As such, any adjustment to the initial allowance based on perceived efficiency improvements or implicit allowance should be supported by robust evidence.

After 10 years, at the following price review (i.e., PR34) the costs spent against the enhancement drivers in 2030 35 would be added to the historic base expenditure when creating the Botex models.

We see no reason that this gap in the regulatory process from PR19 (that this part of the methodology is intending to address) could not be rectified as part of PR24 by retrospectively applying this process. i.e., allowing efficient ongoing enhancement costs of the AMP7 enhancement programmes which are otherwise being registered as inefficient expenditure (because they are not captured in the models).

Annex 3: Risk and return, financeability and financial resilience

Within this annex we have provided further detail to accompany question responses relating to chapters 7 to 9.

The approach to risk and return requires consideration of a set of detailed points, with many that are theoretical and technical. Therefore, we would like to draw out in this introduction the more important aspects of Ofwat's proposals across chapters 7 to 9 and their consequences.

In light of the significant concerns that we have with a number of the proposals within the draft methodology, we together with 13 other water companies, have jointly commissioned a number of expert reports on the key matters. The following reports will shortly be found on Ofwat's Future Ideas Lab.

- Risk free rate by First Economics
- Risk free rate by Oxera
- Setting Notional gearing by Frontier Economics
- Estimation of Beta and treatment of de and re levering by KPMG
- Cross Checks for the Cost of equity MARs by KPMG

We have summarised the key elements where appropriate in our responses to the individual questions. The key aspects we would like to highlight are:

Consistency and regulatory precedent: Consistency is a key factor in ensuring investors believe there is a "fair bet" of ensuring a fair balance between risk and reward over time. However, throughout the draft methodology Ofwat's proposals contain a number of contradictions, or inconsistencies with other proposals.

It is noticeable that in all instances where there are inconsistencies in approach from PR19 these would most likely result in a reduction to the allowed return or weakening of the financeability assessment. Examples of this include:

- Generally, Ofwat has chosen to disregard the conclusions reached by the CMA in redetermining PR19 for Yorkshire Water and the other referring companies.
- Proposed changes to averaging periods, forward rate assumptions and the proportion of new debt will all result in lower outcomes as the market moves from a declining market to an increasing one.
- Ofwat's notional gearing proposals are inconsistent with both its proposals for other key notional debt assumptions and the core ratings agency assumptions that underpin the notional company's target rating of BBB+/Baa1.
- Ofwat cites increasing risk as a reason for lowering notional gearing but fails to recognise any increased risk in proposed RoRE ranges.
- Known business plan incentives are included in RoRE ranges but known cost of debt variances are not to be included.

Whilst individually potentially low it is likely the cumulative impact of all these changes will have a material impact on the allowed return and the balance of risk and return. On this basis we consider it critical that Ofwat maintains the CMA's position of the primary role of WACC in ensuring the notionally efficient firm is financeable.

Lack of evidence: As noted above, regulatory precedent is a key element of investor confidence in the water sector. If there is to be a change from regulatory precedent, there needs to be substantive evidence to support this change; however, there is a lack of compelling evidence presented by Ofwat within its draft methodology to support any of the changes proposed. Examples of this include:

- When discounting the CMA's PR19 conclusions, Ofwat seeks to rely on the "not wrong" outcome of the CMA's RIIO2 conclusions. However, when considering the CMA's conclusions on other appeals, it is essential to consider the scope of these appeals, the criteria for the CMA to overturn a regulator's determination and the different characteristics of regulated sectors. It is noticeable for the NATS, PR19 and RIIO 2 appeals that the CMA did treat each as distinct and separate in reaching its conclusions.
- Ofwat has provided no compelling evidence to support its proposed reduction to notional gearing.
- Ofwat continues to suggest outperformance of new debt, despite the CMA rejecting this assertion after reviewing extensive evidence.
- Ofwat continues to use AMP6 historic performance as evidence to support its proposed RoRE ranges; however, performance data to date in AMP7 clearly shows AMP6 data is no longer applicable given the significant changes implemented at PR19.

Notional structure and financeability: We do not agree with the proposed changes to the notional capital structure and cannot see any compelling reasons for the proposed changes.

We are concerned that the proposed changes to the notional structure are being made with the impact on cashflows and financeability in mind. Therefore, we have serious misgivings about the independence and rigour of Ofwat's proposed financeability assessment. Such an approach can only undermine confidence in the integrity of the price review process, which will not be in the long term interests of customers.

Financial resilience: The draft methodology, together with Ofwat's further consultation on proposed modifications to strengthen the ring fencing licence conditions continues to illustrate Ofwat's very narrow focus on gearing and credit ratings when assessing financial resilience.

We refer Ofwat to our Future Ideas Lab submission on financial resilience[9] which provides a much broader framework for assessing resilience. We will comment further on these matters in our response to that consultation.

Question 7.1 - Do you have any comments on our approach to the overall balance of the PR24 incentive package, our proposed guidance on producing risk ranges, and our view of the balance of risk facing the notional company?

We welcome Ofwat's acknowledgement of the "fair bet" principle that ensures a fair balance between risk and reward; however, we remain concerned as to how this will be implemented in practice.

We are concerned that the proposed approach involves notional RoRE ranges set solely by Ofwat, with a primary focus on historical data without considering the additional impact of the changes forecast at PR24. Experience to date in AMP7 shows clearly that historical performance in AMP6 (as used at PR19) was not a good guide for future performance and therefore believe this approach needs to be reviewed for the final methodology to avoid a repeat of what is being experienced in AMP7.

In order to ensure Investors can have the confidence that a "fair bet" has been delivered there needs to be a more collaborative approach between companies and Ofwat in the preparation of notional risk and reward ranges.

The initial RoRE range presented by Ofwat is roughly symmetrical and based purely on AMP6 data; however, data to date in AMP7 indicates a very different picture.

Analysis of performance data in the first 2 years of AMP7 shows a significant negative skew in performance Total sector P10/P90 operational RoRE before exceptional items of 4.31%/+1.04% and equivalent WASC performance of 5.27%/+1.31%.

The data above clearly contradicts the roughly symmetrical notional risk range presented by Ofwat at PR19, which was calculated on the basis of AMP6 actual data, highlighting that historical performance is not a good guide for future performance, when step changes in performance are required.

This evidence suggests historical performance (particularly that prior to FY21) is a poor guide to future RoRE ranges; therefore, Ofwat needs to reconsider its future ranges in light of AMP7 data and further step changes in performance anticipated as part of PR24 to ensure there is not a further mismatch at PR24.

Further, ODI performance to date is currently enhanced by bespoke performance commitments, whose contribution will be materially reduced at PR24. If AMP7 RoRE data reflected only common PC's the performance range

[9] https://www.ofwat.gov.uk/wp-content/uploads/2022/07/Yorkshire_Water_Assessing_Financial_Resilience.pdf

would be more negatively skewed than presented above. (WASC common PC P10/P90 range of 1.84%/ 0.03% versus ODI total range of 1.84%/+0.40%). The ODI rewards and penalties at PR24 will need to be set carefully to ensure Ofwat's desired symmetrical range, particularly given the inclusion of certain penalty only commitments.

On the key theme of inconsistency and contradictions throughout the proposed methodology we note the inconsistency of Ofwat's assertions in relation to notional structure, where higher risk is used to justify a reduction in notional gearing, but this additional risk does not appear to be included within Ofwat's RoRE risk range analysis.

We also disagree with Ofwat's proposal to exclude benchmarking risks or rewards within embedded cost of debt from the RoRE analysis. Whilst the quantum will be known, we expect the risk / return to vary materially between companies; therefore, it would be inappropriate to exclude this risk / return from either the base return or the risk range when comparing total RoRE ranges across the industry.

For example, based on the data used by the CMA to determine the PR19 cost of debt we estimate a P10/P90 range of 0.8%/+1.4%. Updating this analysis for FY22 APR data suggests a P10/P90 range of 1.4%/+1.1%. These figures clearly show that the current proposed embedded cost of debt approach of using a single industry wide allowance results in a significant variation in risk / reward ranges across the industry. As noted in our prior submissions these variations are primarily due to timing, rather than efficiency; therefore, we believe the cost of debt approach needs to be changed (see Question 7.5) or the discrepancy in risk / reward ranges needs to be addressed.

From a consistency point of view, we also note that the business plan incentive has been included despite this also being “known”.

In relation to the calculation of specific elements, particularly cost and ODI ranges we continue to believe there needs to be greater transparency and consistency across the industry. We comment further on these specific areas in Question 7.3.

In relation to financing risk we also note that the CMA confirmed that there was no evidence of outperformance on the cost of new debt. We comment further on this specific issue in Question 7.5.

Question 7.4 - Do you agree with our proposed approach to setting the allowed return on equity?

In line with our response to the December discussion paper we remain concerned that Ofwat appears to be rejecting all of the decisions made by the CMA as part of the PR19 redetermination. The adoption of alternative policies on the basis that they have been deemed “not wrong” by the CMA RIIO2 appeals does not provide the optimal solution. The CMA PR19 appeal remains the last full regulatory determination of the cost of equity for the water sector and there should be a substantially high bar of evidence to deviate from its conclusions by adopting decisions for a different sector.

In response to these concerns, we together with 13 other companies commissioned the following expert reports on the core elements of cost of equity:

- Risk free rate by First Economics
- Risk free rate by Oxera
- Estimation of Beta and treatment of de and relevering by KPMG
- Cross Checks for the Cost of equity MARs by KPMG

These reports will be available on the Future Ideas Lab and the key elements on each of the specific areas of cost of equity discussed in more detail below.

Risk free rate (RFR): Our response on RFR needs to be read in conjunction with Question 7.6. In light of the issues highlighted by First Economics we believe Ofwat needs to reconsider fully its assumptions in relation to the RFR.

Oxera's report on RFR provides evidence of the existence of a convenience yield in the returns of gilts, which indicates that Ofwat's proposed gilt yield approach is likely to provide an underestimation of the true RFR.

Oxera also acknowledge that the existence of small risk and liquidity premiums mean that AAA bonds are likely to overstate the RFR. Given the complexity involved in estimating convenience yields and risk and liquidity premiums we agree with the CMA and Oxera that an average between the yield on AAA corporate bonds and the yield on gilts provides the best approximation of the RFR.

Further comment on the index conversion issues raised in relation to RFR is provided in our response to Question 7.6.

In addition, we disagree with the proposal to change the averaging period for assessing the RFR from 1 6 months to 6 12 months. As we have moved from a falling market at PR19 (where a shorter averaging period results in a lower rate) to a rising market at PR24 (where a longer averaging period will result in a lower rate) this change in approach introduces inconsistency and presents opportunistically in keeping the RFR at a lower level. We request that further evidence is presented to support this change.

As noted in the introduction consistency of approach is critical to ensure investors believe there is a "fair bet" of earning a fair return. The arbitrary changing of averaging periods across different price reviews for no good reason will erode investor confidence. We see no evidence to change the policy from PR19 of using a shorter averaging period.

Similarly, in relation to forward rate adjustments, the proposed change will have a negative impact on returns given the shift from a falling market to a rising one. Whilst the information presented shows that yields have historically been overstated in a falling market, no evidence has been provided of the impact in a rising market. Further evidence needs to be obtained over the next couple of years before a forward adjustment is totally discounted. In the absence of indexation, it will be critical that the chosen rate is as accurate as possible for the time period it relates to. In particular we refer to Ofgem's draft RFR which includes a forward rate uplift of 0.50% over the next five years.

Total market return (TMR): The variations between the new CPIH dataset and the prior CPI dataset highlight the uncertainty in relation to historic inflation series and we do not believe the existence of this new CPIH dataset provides a definitive view on the optimal historical series to use. On this basis we believe there is insufficient evidence to support a change from the CMA's approach of considering both the RPI and CPI/CPIH historical datasets.

Beta: We disagree with Ofwat's proposed approach to ensure a more consistent CAPM WACC through adjustment of debt beta.

In line with our response[10] to Ofwat's Financial Resilience discussion paper (2021) and First Economics' RFR paper we note that the concerns Ofwat has in relation to re levering beta are not an issue if an appropriate RFR is used. For example, First Economics analysis shows that if a RFR of c 0.7% is used (similar to Ofgem's draft RFR of 0.74%) then the WACC variance disappears, providing a consistent CAPM WACC.

KPMG's report on beta highlights material downwards movements in beta in the periods involving Covid 19 and the Russia / Ukraine conflict to date. These are still on going events; therefore, as noted in our prior response we believe it is too early at this stage to discount applying bespoke weights to this data as Ofwat suggests.

In addition, KPMG note that risk at PR24 will be at least as high as at PR19; therefore, beta at PR24 would be expected to be flat or increasing. The current evidence presented by KPMG suggests that this will not be the case; therefore, we believe applying bespoke weighting to these events needs to be considered.

Point estimate / Aiming up: We remain concerned that Ofwat continues to ignore a key aspect of the CMA's PR19 determination, namely the primary role of WACC in ensuring the notionally efficient firm is financeable.

Ofwat has reiterated its desire to resolve any potential negative skew at source, rather than through an adjustment to WACC; however as noted in our response to Question 7.1 there are currently large amounts of negative skew that are not being identified or addressed by Ofwat.

As referenced in Question 7.1 above in order to provide investors with the comfort that risk is symmetrically skewed at source, the production of RoRE ranges needs to involve a more collaborative approach between Ofwat and the companies.

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[10] https://www.ofwat.gov.uk/wp-content/uploads/2021/12/Yorkshire-Water-Financial-Resilience-response_Redacted.pdf

Cross checks to the CAPM cost of equity: We disagree with Ofwat's view that Market to Asset Ratio (MAR) analysis provides an important cross check to the CAPM cost of equity.

KPMG's report on MAR analysis highlights a number of issues in relation to MAR analysis and concludes that there are better options than MAR analysis for use as cross checks on the allowed cost of equity, such as multi factor models (MFM) and financeability tests.

We believe further work should be undertaken to assess these potential alternatives and note that KPMG are currently conducting further analysis into MFM's.

Question 7.5 - Do you agree with our proposed approach to setting the allowed return on debt?

We have split our response to this question between the key elements of cost of debt.

Embedded debt: As noted in our response to the December discussion paper we agree with the broad overall approach to embedded debt of using a balance sheet approach supported by an index cross check. We also agree with the proposal to use long run inflation forecasts; however, we have a number of concerns in relation to the additional detail provided by Ofwat to date.

- We remain of the view that the allowance should be set on an individual company basis, rather than the single sector allowance currently used, for efficiently raised debt. The current approach results in an arbitrary set of "winners and losers" as noted on p29 of Appendix 11; however, we disagree with Ofwat on the reasons for this. These variances are primarily caused by the timing at which debt was raised and whether it was fixed or floating in nature and we note there are other factors to consider such as tenor at issue, ratings and amount of debt raised.

  It is inappropriate to penalise companies that have taken out efficient long term fixed rate debt that would have been considered the prudent decision at the time, whilst rewarding any companies that have benefited from taking out "riskier" short term floating rate debt at the same time, as markets have subsequently fallen.

  As noted in Question 7.1 the variances resulting from this approach are material the data used by the CMA to determine the PR19 cost of debt results in an estimated PR19 P10/P90 RoRE range of 0.8%/+1.4%. Updating this analysis for FY22 APR data suggests a P10/P90 range of 1.4%/+1.1% for PR24. These are significant variances which require further attention if a fair balance of risk and reward across the sector is to be achieved at PR24.

- We are very concerned by the suggestion that a 15 year collapsing average, resulting in a 7.5 year average maturity, would provide a cross check for the upper limit of the allowance. The CMA used a cross check range of between 15 years and 20 years on a collapsing average basis and Ofwat has provided insufficient evidence at this time to deviate from this assumption.

  FY22 APR data continues to show that the sector has a weighted average debt maturity of c12.5 years, which equates to an average tenor at issue of c25 years a more appropriate tenor to finance long term assets. Whilst companies might recently have raised debt at slightly shorter tenors as indicated by Ofwat, it is the total debt portfolio that needs to be considered. Further analysis of FY22 APR data also indicates that the approach proposed by Ofwat would result in an allowance at FY22 that sits between the 15 and 20 year collapsing averages at FY22.

  On this basis, it is inappropriate at this early stage to seek to limit the range of the proposed cross check.

- Ofwat has used a generic term of "interest rate swaps" and further clarity is required as to whether Ofwat plans to exclude all swaps, or just certain categories. We agree that the treatment of swaps needs to be applied consistently across notional debt assumptions if swaps are excluded from the assessment of embedded debt then they must also be excluded when considering the proportion of index linked debt.
- Ofwat should state its preferred estimation and averaging methods ahead of conducting the detailed analysis to ensure full transparency of the process. The current proposal leaves the impression that the preferred method will be chosen on the basis of achieving Ofwat's desired result, rather than necessarily the optimum theoretical approach. This is particularly concerning given the comments above in relation to Ofwat's preconceived notion that the allowance should not be higher than the 15 year collapsing average.
- We do not understand why there cannot be full transparency of all calculations. All of the data will be collated from Table 4B of APR's which are published publicly in full; therefore, we see no confidentiality reasons for not providing full transparency. Given the number of adjustments being proposed by Ofwat it will be critical to ensure there is full transparency in relation to the calculations.

New debt: It is very disappointing to see that Ofwat continues to suggest that there is outperformance against new debt, when significant amounts of evidence on this matter were presented to the CMA, who concluded there was no evidence of outperformance once there had been adjustments for tenor and rating.

Ofwat has not presented any new evidence to invalidate the conclusions of the CMA; therefore, we do not believe there is any potential issue in relation to a discount to the benchmark index that needs addressing. On this basis, we support option c) No adjustment.

Consistent with our response to Question 7.4 above on RFR we disagree with the proposed change to the averaging period. Consistency of approach in these matters is critical, whilst picking and choosing alternative methods as the market moves in different directions gives the impression of attempting to influence results as low as possible.

Similarly to Question 7.4, we also disagree with the lack of a forward adjustment. Whilst indexation protects against forecast error in this instance, we still believe the allowance should most accurately reflect the expected costs across the period to mitigate the quantum of adjustments required in subsequent periods.

Debt mix: We agree with the proposed "actual" approach to ensure consistency with the approach proposed for embedded debt.

Whilst agreeing with this particular approach, this is a further example of Ofwat changing an approach from PR19, or selectively picking the CMA conclusions that will most likely result in a reduction in the allowed return.

All of the proposed changes in the draft methodology appear to result in a reduced return. Whilst individually potentially low it is likely the cumulative impact of all these changes will have a material impact on the allowed return. On this basis we consider it critical that Ofwat maintains the CMA's position of the primary role of WACC in ensuring the notionally efficient firm is financeable.

Question 7.6 - 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 disagree with Ofwat's preference of an "official forecasts" approach.

As noted by First Economics in their RFR report the expectations that matter when converting yields on RPI indexed gilts are not the RPI expectations of any individual forecaster, such as the OBR. In order to obtain a genuine market based estimate of the return that investors are willing to accept on a riskless asset, the conversion of RPI real yield has to capture the expectations that buyers of index linked gilts have as they make their purchases.

Our view is that the break even inflation (the difference between the yield on nominal and index linked gilts) best illustrates the inflation expectations of investors. As illustrated within Figure 4 of First Economics RFR report these break even expectations are markedly different to the equivalent "official forecasts" which have been proposed by Ofwat.

As noted by Oxera in their RFR report there is also a broadening wedge between CPI and CPIH that is not currently considered within Ofwat's "official forecasts" approach.

As noted in Question 7.4 First Economics have also identified a link between RFR and Ofwat's concerns in relation to the re levering of beta. The analysis provided within Section 3 of First Economics RFR report illustrates that the re levering issues highlighted by Ofwat are likely to have been caused by the selection of the RFR. Rather than increasing debt beta to implausibly high levels to resolve the issue, we believe Ofwat needs to revisit its assumptions in relation to RFR.

Question 7.7 - Do you agree with our proposed approach to the notional structure and setting allowances for corporation tax?

We strongly disagree with the proposed changes to the notional structure. It is unclear as to the basis of Ofwat's judgement as regulator to propose these changes and this requires further justification when considering references to strengthening equity buffers, yet continuing to assess financeability solely through a cash flow lens. We believe that an opportunity has been missed for Ofwat to demonstrate practically how an increased equity buffer can substantially benefit the financeability of the notional company as opposed to determining a price review in line with its building blocks approach.

We are particularly concerned, given the widespread objections to the proposals to reduce notional gearing within the December discussion paper, that Ofwat has chosen not to formally consult on its intentions at this stage, choosing instead to simply provide its decision with the final methodology. It does not present as an engaged process that allows water companies and other key stakeholders to understand and participate fully in this consultation on the PR24 methodology.

Frontier Economics report on notional gearing concludes that Ofwat has not provided any empirical evidence to support its proposal to reduce notional gearing from the PR19 level of 60%. Frontier Economics also conclude that Ofwat's proposals are not consistent with Ofwat's own notional gearing framework.

Frontier Economics propose their own approach for assessing notional gearing in practice, which considers the following four questions:

1. What is the market evidence on gearing?
2. Is there a case to set notional gearing at a different level?
3. Is notional gearing the best tool to provide additional headroom for risk?
4. Is the treatment of notional gearing in line with regulatory best practice?

They conclude that the answer to each of these questions in relation to Ofwat's proposal is no. Frontier Economics note that they have seen no empirical evidence to suggest that the current notional gearing level of 60% is inconsistent with the market evidence or provides insufficient headroom to face future uncertainty. Furthermore, Ofwat have presented no analysis to show that it has considered financeability in the round and that adjusting the notional gearing level is the best option for providing greater headroom.

When Ofwat provides its final decision on notional gearing we believe it needs to address these four questions.

One of Ofwat's principal justifications for a change in notional gearing appears to be a change in the balance of risk; however, Ofwat has not referenced a change in the balance of risk when considering risk ranges earlier in this chapter. Instead, a risk range slightly skewed to the upside has been presented; a further example of an inconsistent approach in the draft methodology.

The water sector is also considered to be the least risky of the regulated sectors, as evidenced by the betas applied, so it appears contradictory and flawed to justify water companies having the lowest notional gearing on the basis of risk.

We note that whilst Ofwat considers "*it is important to set a **consistent framework** to determine the appropriate notional capital structure*" [p21] and also states that "*we intend **to apply consistent approaches** between the cost of embedded debt and the level of index linked debt*" [p25] (namely a sector average approach) when it comes to notional gearing, the third key element of notional debt assumptions, Ofwat intends to apply a totally inconsistent approach to both:

1. The sector average approach proposed for the two other key notional debt assumptions; and
2. The core ratings agency assumptions that underpin the notional company's target rating

Whilst credit ratings are an "in the round" assessment as Ofwat notes, the target credit rating and the associated parameters that make up that rating are a critical element of the notional structure. It is critical that all the metrics normally associated with the target rating are applied consistently.

We agree with Ofwat that a consistent framework is essential. Consistency is a key element for investor confidence by ensuring the "fair bet" principle is upheld. On this basis we see no evidence to reduce the notional gearing, in fact the evidence would suggest a rise in notional gearing would be more appropriate.

We also note that Ofwat is keen to stress that the notional structure will be set "*in advance of, and independent to*" the financeability assessment.

Whilst in practice this will be the case, the fact that all the proposed changes to the notional structure will improve financeability, plus Ofwat's prior question in relation to financeability being less constrained (which specifically noted that the proposed changes would improve financeability), clearly suggests that the proposed changes are being made with financeability in mind. This is supported by Ofwat's submissions to the CMA where these proposed changes to the notional structure were presented as potential solutions to the financeability constraints that arose at PR19.

We are concerned that at present the proposed changes to the notional structure are primarily being made with financeability in mind and that the ultimate financeability assessment will be tainted because of this. In order to ensure that the financeability assessment is fully independent of any changes to the notional structure, the assessment should be made considering a notional structure before and after any changes from PR19.

In relation to the proportion of index linked debt we support an approach that is consistent across all notional assumptions, including gearing. If an actual approach is adopted for the notional proportion of index linked then actual data needs to be reflected within the notional gearing assessment. There also needs to be total consistency with the approach to the cost of embedded debt. If junior, subordinated or class B debt is excluded from that assessment, then any such index linked debt also needs to be excluded when determining the proportion of index linked debt.

Finally, there is no comment on how the cost of debt of debt will be calculated within the financeability metrics. Given the full transition to CPIH and the real return being calculated on this basis, in order to ensure consistency it is critical that index linked debt is also calculated on a CPIH basis. This would also ensure a consistent approach with other regulators, such as Ofgem, that have also fully transitioned to CPIH. The current draft model includes calculations on a RPI basis, which understates the debt costs; therefore should be changed to a CPIH basis.

Corporation tax: We broadly agree with the proposals in relation to corporation tax which are consistent with previous price controls. In relation to subsequent changes in gearing any claw back mechanism should be symmetrical for both increases and decreases in gearing.

Question 8.1 - Do you agree with our approach to assessing financeability?

Our response to this question needs to be read in conjunction with our response to Question 7.7. Given the proposed amendments to the notional structure we have serious reservations about the independence and rigour of Ofwat's proposed financeability assessment. Any doubts about this assessment can only erode investor confidence, which will not be in the long term interests of customers.

As noted in our response to the December discussion paper, we do not agree that financeability is simply a test of sufficiency of cash flows in PR24, especially if the discredited approach of revenue advancement is included. This is a repeat of the short term focused approach taken by Ofwat at PR19, which we continue to believe will undermine confidence in the overall integrity of the price review process and contradicts the ambition to focus on the long term.

It is disappointing to see Ofwat continually seeking to break the clear links between WACC and financeability that were a core element of the CMA's redetermination. It is critical to the long term financeability of the sector that the conclusions of another regulator such as the CMA are not ignored so easily and in such a short time period, otherwise this will impact long term investor appetite that is likely to result in increased costs being borne by customers in the future. This is particularly relevant given the references to reducing dividend yield and applying tranches of additional equity finance when addressing financeability constraints.

Stress testing is a key element of any financeability testing, but it appears to be missing from Ofwat's proposed approach. Ofwat has proposed a number of sensitivities for companies to run as part of actual financial resilience testing but does not appear to believe they should also be run from a notional point of view as part of their financeability analysis. We have submitted a resilience framework to Ofwat's Future Ideas Lab which we believe provides an appropriate framework for stress testing the notional company as well as actual financial resilience.

Our view is that sensitivity analysis is critical. One of the key reasons for targeting a notional credit rating two notches above the minimum target level is to ensure there is adequate headroom to absorb any reasonable cost shocks. It is therefore critical to ensure that the notional company has adequate headroom to absorb the sensitivities proposed by Ofwat.

This two notch headroom level has been a key part of financeability assessments for a number of price reviews. Ofwat's proposals in the proposed modifications to strengthen the ring fencing licence conditions consultation (July 2022) to amend the licence to increase the minimum credit rating at which cash lock up occurs by one notch means that the target rating of the notional company must be increased by one notch to A /A3 to ensure the current two notches of headroom are maintained. We will comment further on this issue in our response to that consultation. As noted within our responses in the prior section, Ofwat's proposals to reduce notional gearing also suggest that the target rating will need increasing to A /A3.

Question 8.2 - Do you agree with the focus on the metrics outlined in section 8.4 for the assessment of financeability?

As noted in Question 8.1 we are concerned that there appears to be no change from the financeability approach at PR19 that was rejected by the CMA. The metrics proposed in section 8.4 continue to include flawed calculations of cash flow measures, such as interest cover (ICR) and funds from operations to net debt (FFO/Debt) that bear no resemblance to the calculations used by the ratings agencies. We believe this undermines the credibility of any financeability analysis.

Our view is that cash flow measures such as ICR and FFO/Debt that consider the ability to service and repay debt from operating cashflows are more important when assessing financeability or financial resilience. In order to ensure these metrics are in accordance with the proposed target rating it is critical to ensure the calculations are as close as possible to those used by the ratings agencies. We see little point in monitoring metrics that bear no resemblance to the target rating.

Whilst the other metrics proposed, such as gearing and dividend cover are important, we consider these to be secondary to the key metrics of ICR and FFO/Debt.

On this basis we believe the following two metrics have primary relevance to the financeability assessment and ensuring they are within the thresholds of the target rating will be critical:

- Adjusted cash interest cover ratio, calculated in accordance with Fitch and Moody's methodology (equivalent to Ofwat's alternative measure)
- FFO to debt, calculated in accordance with S&P's methodology (equivalent to Ofwat's alternative measure)

The following metrics are considered to be of secondary relevance:

- Gearing
- Dividend cover
- Retained cash flow
- Return on capital employed
- Return on regulated equity

As noted in Question 7.7 index linked interest costs need to be calculated on a CPIH, rather than RPI basis to ensure consistency with all other elements of the metrics which are calculated on a CPIH basis. Within the proposed calculations in the financial model this is not currently the case.

Question 8.3 - 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 broadly agree with the proposed approach in relation to PAYG rates.

Whilst we agree with the theory of setting RCV run off rates based on the remaining assets lives, as that is the approach, we adopted at PR19, we are concerned by the proposed approach of stipulating a narrow range. Companies will have different asset life policies and will be at different stages of their asset cycle across the different asset categories; therefore, a predetermined narrow range may not be appropriate for all companies. Our preference would be to retain the existing approach, whilst potentially increasing the challenge applied to company's chosen rates.

We are unclear exactly how Figure 5.1 has been calculated, but believe this chart overstates any potential concern in relation to run off rates as it does not reflect enhancement expenditure. A large amount of the run off charged across the period relates to enhancement expenditure; therefore, it is inappropriate to exclude these costs from the analysis.

The suggestion that slightly inflated run off rates could lead to future financial resilience issues is also significantly overstating the potential impact of run off rates.

Question 8.4 - Do you agree with our proposed approach to resolving a financeability constraint?

We disagree with the proposed approaches to resolving a financeability constraint and have touched on this in our response to Question 8.1 regarding the short term nature of proposals and the attractiveness to investors

In particular, as noted in our response to the December discussion paper we disagree with the notion that gearing needs to remain consistent every year, we consider it to be entirely reasonable for increases in gearing during periods of higher investment. This is a further example of the narrow focus on gearing as a financeability or financial resilience measure.

If there is a material financeability constraint, higher investment is unlikely to be the main cause as cash flow metrics like ICR are relatively insensitive to capital expenditure, particularly in periods of low interest rates. We note the challenges facing water companies predominantly impact operating cash flows, including climate change consequences, customers' ability to pay bills on time, and volatile energy markets before and after the Russian invasion of Ukraine.

Similarly, equity injections as a potential solution to a constraint are not a particularly effective solution to address the impact of operating cash flow challenges on ICRs. Significant amounts of equity can be required and the benefit can take time to realise if the equity injection remains as cash. The cost / benefit of the equity injection can then be considered disproportionate in comparison to other solutions and not the optimal outcome for customers.

For example, looking at PR19 notional ICR, a 10bp constraint would require an equity injection of c£300m to resolve, assuming the full benefit would be received immediately. Based on a 5% issuance cost and ongoing 4% dividend yield this would cost the customer c£27m in year 1, with an ongoing cost of c£12m. In contrast an alternative solution through adjusting the WACC would more effectively resolve the constraint, whilst costing less in total (c£13m pa).

The above example illustrates that where there is a material constraint across the sector (as was the case at PR19) it needs to be recognised that the cause is not purely investment related and an alternative approach is required. In this case we note the CMA's conclusion in relation to the primary role of WACC in ensuring the notionally efficient firm is financeable. This is important as it recognises the clear link between financeability and the allowed return to be paid to the providers of debt and equity capital.

Our view remains that the best approach to resolving a financeability constraint is through the WACC, as the CMA concluded from its cross checks within the PR19 redeterminations.

We agree that a reasonable minimum dividend yield needs to be retained to maintain investor appetite, otherwise equity injections could not even be considered a potential solution.

Question 9.1 - Do you agree with the proposed standard set of scenarios for testing financial resilience?

We agree that there is benefit in having a standard set of scenarios across all companies to enable consistent assessment across the sector; however, we believe specific scenarios determined by the companies (similar to those adopted within their long term viability statements) should have the greatest importance when considering financial resilience.

In relation to the proposed set of scenarios we would make the following comments:

- The totex scenario appears reasonable; however, we would broaden this to also include retail costs
- In relation to ODI's we believe a lower annual penalty would be a more realistic downside (e.g., 1% of RoRE per annum as used by the CMA) than a single large one off penalty.
- The inflation scenarios proposed do not reflect the key risk experienced by companies over the last few months, namely "super" inflation on certain costs such as energy and chemicals and the differences between average inflation and prior November inflation which impacts revenue in periods of rapidly rising inflation. We believe the high inflation scenario should recognise a situation where costs increase by more than CPIH or RPI.
- Bad debt costs are relatively immaterial in comparison to energy costs or the proposed totex scenario; therefore, we question the need to pick out bad debt as the sole cost to focus on.

We agree with the use of reverse stress testing, but further clarity on the operation of this is required, as the current draft data tables do not appear to maximise the potential.

We see little benefit in companies assessing how much Ofwat's view of cost and revenue allowances may differ from their own. Companies set out plans that they consider to be efficient, whilst also providing a fair balance of risk and reward. On this basis if the company has prepared their plan properly, they would not expect any adjustment.

Question 9.3 - Do you agree with our proposed approach to dividend policies, performance related executive pay and voluntary sharing of financial outperformance?

We broadly agree with the approach to dividend policies, noting that the approach is very similar to that proposed at PR19 and also adopted by YW within our own dividend policy.

However, we disagree with the proposal in relation to dividends used to fund inter company interest. Where dividends are immediately paid back to the regulated company in the form of interest, such that there is no impact on the cash balance or the reserves of the regulated company we see no need to include those dividends within the dividend policy.

Finally, when considering the impacts of inflation, it is also important to consider additional real price effect inflation over and above CPIH or RPI in relation to costs, such as energy where cost inflation has recently been significantly above CPIH.

In relation to voluntary sharing of outperformance, the financial outperformance highlighted predominantly occurs due to the proposed single allowance approach to the cost of debt. As noted in our response to Question 7.5 this approach results in a significant variation in returns across the sector. We agree that something needs to be done to address this imbalance in performance across the sector but believe this would be best addressed at source by setting individual company allowances, rather than a sector wide allowance. This would ensure consistency with other elements of risk and reward where Ofwat proposes to resolve any issues at source.

Once these financial returns are excluded, our view is that the remaining potential outperformance to be shared is relatively minimal.

- When considering high inflation, we consider the higher returns illustrated by Ofwat to be “spreadsheet” returns rather than cash returns, which arise on the assumption nominal debt costs fluctuate with short term actual inflation, rather than long term inflation forecasts. The impact of higher costs and lost revenue has also been excluded.
- In relation to tax we believe the current mechanisms catch all relevant changes. In relation to disclaimed capital allowances we note that allowance pools are reset at the beginning of each AMP when calculating tax allowances; therefore, customers already receive the benefit of any disclaimed capital allowances in the following AMP.

Finally. we note the footnote reference to a gearing outperformance sharing mechanism (GOSM) on p87 of the consultation and recent comments in the Water Report by the prior Ofwat Chairman which suggest that Ofwat have plans to introduce some form of GOSM without the opportunity for companies to be consulted. Given the CMA categorically rejected the prior GOSM introduced at PR19 and Ofwat has not produced any new evidence on the matter we believe further consultation will be critical. It is concerning that such a contentious disproven mechanism is potentially being resurrected by Ofwat without any consultation prior to publication of the PR24 final methodology.