

## PR14 review – call for input

### Response from Severn Trent Water and Hafren Dyfrdwy

We welcome the opportunity to comment on your [PR14 review - call for input](#). We've reflected on what our customers told us at PR19 they wanted the sector to deliver. In our response we suggest how the PR14 regulatory regime could develop to help deliver for our customers.

The **outcomes approach** introduced at PR14 has led to a step-change improvement in service performance for customers since 2015 and is leading to more over the next 5 years. For example, in the last price review, the industry signed up to a 16% reduction in leakage. Companies are also incentivised by outperformance payments to innovate and deliver beyond their commitments for customers and we consider it's important Ofwat retains strong outperformance incentives for this reason. We're aware a criticism of the outcomes approach is that could be short-term focussed. We don't think this criticism is valid, but if Ofwat signalled the outcomes approach will continue over several price controls we think it would encourage further investment in long-term improvements to customer services.

**Bespoke ODIs** are a vital part of the outcomes approach that Ofwat introduced at PR14. Bespoke ODIs allow companies to reflect their customers' and communities' local concerns, and keep up with these as they evolve over time. They also allow for companies to experiment with innovative approaches, which the whole industry can learn from to improve services. We strongly support retaining a large role for bespoke ODIs.

The **totex approach** has given companies more freedom to invest where their services to customers most need it. The flexibility that the totex approach provides will be even more appropriate as we face into new challenges that require innovative approaches such as achieving net zero, improving biodiversity and managing nature's scarce water resources. We think it's important for the totex approach to allow companies to propose and Ofwat to approve solutions that deliver the best whole-life value for customers over the long term.

The **econometric models** generally work well to make sure water companies' allowances for repeatable activities are efficient. The challenge is that the econometric models suffer from being backwards looking and being unable to take account of future challenges such as: achieving net zero; eliminating harm from storm overflows; removing lead from pipes; and achieving the new 1-in-500 level of drought resilience. We suggest one way Ofwat could take account of these drawbacks would be to allow additional efficient expenditure where the future needs to be different, in line with the Ofwat strategy.

We consider there is a need for Ofwat-approved **multi-AMP investment vehicles** to allow for step-change service improvements for customers, for example for water resource resilience, environmental improvements or a programme of replacing customers' supply pipes that take longer than five years to deliver efficiently. One option would be for Ofwat to determine these schemes outside the price review. This would allow time for a more detailed assessment of large investments and avoid being constrained by the price review timetable.

At PR14 (and again at PR19), the prospect of **fast track rewards** encouraged companies to reveal information in their Business Plans that enabled Ofwat to challenge companies across the sector to provide a better deal for customers. Looking forward, we see a risk that companies think they would be better off not seeking fast track rewards through ambitious business plans because of the smaller rewards at PR19 compared to the CMA's provisional findings and the PR14 rewards. In our view, a solution to this risk would be to increase the size of the fast-track rewards so that the incentive remains genuinely effective.

The PR24 approach to **affordability** needs to be open to allowing average bills to increase, or at least not fall, if that is what's needed to fund the efficient investment to address the sector's future challenges. Water companies can use support measures for those customers who find their bills unaffordable if average bills increase, while allowing investment to improve services for all customers in the future. As part of this approach Ofwat should take account of the absolute level of bills as well as changes in bills, so that companies with relatively low bills are not inappropriately constrained from investing to improve services for their customers.

In relation to **financeability**, we think Ofwat should consider the final CMA decision. This seems likely to place the emphasis on using the weighted average cost of capital (WACC) as the appropriate tool for achieving financeability rather than using financial levers. This approach would help simplify the regulatory model. We also think that Ofwat should consider the impact of its whole price control package, including the effect of past and future incentives, when fulfilling its financeability duty.

We strongly support the increased focus on companies carrying out **customer research** for their business plans since PR14. We welcome that your recent discussion paper on customer preferences recognises that it's vital that water companies understand their customers' needs and preferences – something that we have found to be critically important in developing bespoke ODIs. We will be responding fully to your discussion paper.

We recognise that some **complexity** is inherent in a price control that allows £6,203m of wholesale totex for a company as large as Severn Trent Water. Alongside this, we consider the PR14/PR19 approach could be significantly **simplified for Hafren Dyfrdwy** (HD), which has allowances of just £166m of wholesale totex over five years.

An area that the PR14 review did not put much emphasis on was **public value**, reflecting that the debate has developed considerably in recent years. We welcome your recent discussion paper on public value in the water sector and will be responding to it. We would like to see the role of water companies in delivering social purpose – such as community schemes or helping to educate the workforce – considered in the price review process in some way and we look forward to future discussions on this.

Thank you for the opportunity to contribute to your call for input on the PR14 review. In the annex we respond to the specific questions that relate to our main points.

## Annex: SVE and HDD's responses to Ofwat's specific questions

### 2. Separate controls

Questions	SVE and HDD response
1. To what extent did separating controls improve understanding and transparency of costs in different parts of the value chain (i.e. wholesale water and wastewater; retail business and residential)?	-
2. How effective were the controls at supporting the development of the business retail market for customers of companies operating wholly or mainly in England?	-
3. Do you have any other feedback on this objective?	-

### 3. Focus on delivery

Questions	SVE and HDD response
4. To what extent did PR14 performance commitments reflect outcomes rather than outputs?	Our PR14/PR19 performance commitments focused on services that are important to our customers as was confirmed by our customer engagement. The performance commitments together help deliver the outcomes that our customers want.
5. To what extent did the PR14 outcomes reflect customer priorities throughout the period?	Our PR14 outcomes were developed following extensive engagement with our customers.
6. Did the outcomes framework impact on the way companies contracted with the supply chain during 2015-20?	The ODIs have helped us to align the incentives of our business and contractors much more closely with customers' priorities.
7. Did the outcomes approach affect the way companies operated during 2015-20 in other ways?	The outcomes approach has led to a step-change improvement in service performance for customers since 2015 and is leading to more over the next 5 years. At Severn Trent the outcomes approach has driven a much greater focus on customers' priorities and the framework is built into all aspects of our business, from the weekly team meetings for operational teams to the company bonus.
8. To what extent did the performance commitment levels set accurately reflect the stretch that could be achieved with allowed totex?  Did you observe any differences between comparable and bespoke performance commitments (or any other performance commitments)?	We consider the performance commitment levels set at PR14 were stretching. One of the best ways to assess the overall stretch for outcomes and totex is to look at the cumulative RoRE performance for the AMP. This shows that Ofwat got the balance about right. Bespoke ODIs are a vital part of the outcomes approach that Ofwat introduced at PR14. Bespoke ODIs allow companies to reflect their customers' and communities' local concerns, and keep up with these as they evolve over time.

<p>9. Were financial incentives effective in incentivising companies to improve performance? Where were financial incentives:</p> <p>a. most effective and why; and</p> <p>b. least effective and why?</p>	<p>In our view, financial ODIs are by far the most effective at leading to a step-change improvement in service performance for customers. For example: They allow teams to create more effective business cases that drive improvements for customers or reduce the risk of failure.</p> <p>They support greater alignment of incentives between our business and our customers (for example through our company wide bonus). They crystallise management focus on delivering service improvements for customers.</p>
<p>10. Were reputational incentives effective in incentivising companies to improve performance? Where were reputational incentives:</p> <p>a. most effective and why; and</p> <p>b. least effective and why?</p>	<p>We consider reputational ODIs have a much more limited effect on incentivising companies to improve their services for customers. For example, it's much harder for a team to create a business case that drives improvement without having a financial value for the benefits.</p>
<p>11. What impact did caps, collars and deadbands have on the management of risk and performance? Where were they:</p> <p>a. most effective and why; and</p> <p>b. least effective and why?</p>	<p>Caps, collars and deadbands all remove or dampen the effect of ODIs to incentivise companies to improve their services for customers. We think they should be used sparingly. The use of an aggregate sharing cap at PR19 is a good example.</p>
<p>12. To what extent did CCGs ongoing involvement during the PR14 period help companies to focus on delivery for customers?</p>	<p>CCGs are most effective when focussing on their core role of challenging companies on the quality of their customer engagement and how it has influenced their business plans.</p> <p>We consider the financial incentives from ODIs are much more effective in driving service improvements.</p> <p>It's the role of Boards, not CCGs, to drive delivery for customers. We do not think this is the right role for CCGs.</p>
<p>13. Overall, to what extent did PR14 encourage a greater focus on delivery of outcomes customers wanted, during 2015-20 and longer term?</p>	<p>The outcomes approach introduced at PR14 has led to a step-change improvement in service performance for customers since 2015 and is leading to more over the next 5 years.</p>
<p>14. Do you have any other feedback on this objective?</p>	<p>We're aware a criticism of the outcomes approach is that could be short-term focussed. We don't think this criticism is valid, but if Ofwat signalled the outcomes approach will continue over several price controls we think it would encourage further investment in long-term improvements to customer services.</p>

#### 4. Value for money

Questions	SVE and HDD response
<p>15. To what extent did the move to a totex approach at PR14 encourage more efficient delivery solutions? Was there a more efficient balance of capex and opex expenditure during the 2015-20 period? How did it compare with what was forecast?</p>	<p>The totex approach has given companies more freedom to invest where their services to customers most need it. The flexibility that the totex approach provides will be even more appropriate as we face into new challenges that require innovative approaches such as achieving net zero, improving</p>

	biodiversity and managing nature's scarce water resources.
16. Did companies make use of the option to bring forward investment to 2014-15? Was this option helpful?	In the context of the green economic recovery from the Covid-19 pandemic we see strong benefits for customers, the economy and society of being able to bring forward investments when it is appropriate to do so.
17. How well did the PR14 econometric models assess the efficient level of base costs for water and wastewater?	The econometric models generally work well to make sure water companies' allowances for repeatable activities are efficient. The challenge is that the econometric models suffer from being backwards looking and being unable to take account of future challenges such as: achieving net zero; eliminating harm from storm overflows; removing lead from pipes; and achieving the new 1-in-500 level of drought resilience. We suggest one way Ofwat could take account of these drawbacks would be to allow additional efficient expenditure where the future needs to be different, in line with the Ofwat strategy. We also think the water models are weaker than the wastewater models. This is an area for development at PR24 and we will share more ideas on this in the future.
18. How well did the PR14 approach to assessing enhancement costs work? Were there any notable differences for different categories of expenditure?	We consider there is a need for Ofwat-approved multi-AMP investment vehicles to allow for step-change service improvements for customers, for example for water resource resilience, environmental improvements or a programme of replacing customers' supply pipes that take longer than five years to deliver efficiently. One option would be for Ofwat to determine these schemes outside the price review. This would allow time for a more detailed assessment of large investments and avoid being constrained by the price review timetable.
19. Overall, to what extent did PR14 deliver value for money for customers?	PR14 did deliver value for money for customers. If you look at companies' cumulative RoRE performance you can see that PR14 got the package right.
20. Do you have any other feedback on this objective?	-

## 5. Sustainable use of water resources

Questions	SVE and HDD response
21. To what extent did the water trading incentives encourage companies to look for opportunities to trade water?	
22. To what extent did the abstraction incentive mechanism encourage companies to reduce abstraction in water stressed areas?	We do not think the water resource mechanisms at PR14 have delivered better outcomes for customers.

23. To what extent did the water efficiency performance commitments encourage companies to make better use of water?	In light of the recent Government policy on drought risk and rising consumer demand, there is a question about whether the sector has enough headroom on water resources. Given the decision to set up RAPID at PR19 it would seem that Ofwat and Defra agree a different approach is needed.
24. Overall, to what extent did the PR14 approach encourage more sustainable use of water resources?	
25. Do you have any other feedback on this objective?	

## 6. Balance of risk and return

Questions	SVE and HDD response
26. Do you think PR14 struck the right balance of risk and return between customers, companies and their investors?	Yes, we think the approach was about right. The cumulative RoRE data for a notional company show this balance was fair.
27. How, if at all, did the new approach to setting the cost of debt affect company financing decisions over 2015-20?	-
28. Was greater flexibility around cost recovery (PAYG or RCV run off rates) beneficial in terms of promoting financeability – or more widely?	We think Ofwat should consider the final CMA decision. This seems likely to place the emphasis on using the weighted average cost of capital (WACC) as the appropriate tool for achieving financeability rather than using financial levers. This approach would help simplify the regulatory model. The extra levers and need to engage customers on their use adds significant complexity to the price review process that we don't think is needed.
29. How did our approach to financeability impact on company behaviour during the PR14 period?	-
30. Was the PR14 RoRE analysis helpful in understanding the overall balance of risk and return? Was the information reported by companies and Ofwat in 2015-20 on actual performance on a RoRE basis an effective way of measuring and understanding company performance against the final determinations? Could it have worked better?	We consider RoRE is a useful metric that external stakeholders can use to compare our overall performance to other companies' performance.
31. Were there any ex-post areas of PR14 where companies were assigned risks inappropriately or were exposed to too much or too little risk?	-
32. To what extent did the introduction of the financial monitoring regime at PR14 reduce the risks posed to customers by financial structures?	We consider the Ofwat monitoring financial resilience report provides useful insight. Given that we are a listed company and not highly geared we do not think the question on financial structures is particularly relevant to us.
33. Do you have any other feedback on this objective?	-

## 7. PR14 reconciliation mechanism

Questions	SVE and HDD response
34. How well did the PR14 reconciliation mechanisms work?	-

## 8. General PR14 questions

Questions	SVE and HDD response
35. What do you think the main successes of PR14 were?	The outcomes approach introduced at PR14 has led to a step-change improvement in service performance for customers since 2015 and is leading to more over the next 5 years.
36. Are there any specific areas of PR14 that you think should be improved for future price reviews?	In our covering letter we set out a number of suggestions for how the price review could be improved to benefit customers in the areas of: totex, the econometric models, multi-AMP investment vehicles, fast track rewards, affordability, financeability, simplification for small companies and public value.
37. Based on your experience of PR14, are you aware of any unintended effects (positive or negative) from the policies implemented?	In our covering letter we set out a number of suggestions for how the price review could be improved to benefit customers.
38. What elements of the PR14 objectives are still relevant for future price reviews?	The outcomes approach introduced at PR14 has led to a step-change improvement in service performance for customers since 2015 and is leading to more over the next 5 years.
39. Are there wider considerations that require a change in regulatory approach from PR14?	In our covering letter we set out a number of suggestions for how the price review could be improved to benefit customers.
40. Do you have any other additional information or data that you would like to share with us to assist with the PR14 review?	-
41. If time allows, would you be happy for us to get in touch to discuss your feedback on PR14 in more detail?	Yes, we would be happy to discuss our feedback in more detail.