Ofwat consultation on PR24 and Beyond: Creating tomorrow, together

Severn Trent Water response

22 July 2021

WONDERFUL ON TAP

Contents

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Dear Aileen,

SEVERN TRENT'S RESPONSE TO PR24 AND BEYOND: CREATING TOMORROW, TOGETHER

I welcome the opportunity to contribute to the development of the framework for PR24 and future price reviews.

At Severn Trent we support your vision of a water sector that provides high-quality services that reflect customers' expectations, delivers environmental improvements including healthy rivers and net-zero carbon emissions and continues to provide one of the most affordable water services in the world.

To deliver this vision we agree with you on the need for innovation, new thinking and new investment. The green recovery investment that you recently approved for Severn Trent is a great example of fresh thinking in the water sector. Through the green recovery we will be delivering £566m (2017-18 prices) of investment in innovative schemes to create bathing rivers, build a flood-resilient community through nature-based solutions, reduce health risks from lead pipes, decarbonise water resources, accelerate environmental improvements and install smart meters. These schemes benefit our customers, move towards delivering your vision of the water sector and provide broader public value to our communities.

A key element of the success of the green recovery was both: (i) the constructive engagement with your team at Ofwat; and (ii) the freedom you afforded companies to engage with customers to identify innovative approaches to face into the challenges of the future. We therefore wholeheartedly support you retaining the outcomes and totex frameworks for PR24 that will give companies the flexibility and strong incentives needed to innovate and deliver for their customers.

There are many areas of your proposals that work towards the achievement of your vision and that we support, for example:

- Your four themes for PR24 of: focusing on the long-term; delivering greater environmental and social value; reflecting a clearer understanding of customers and communities; and driving improvements through efficiency and innovation. These align well with our company purpose of 'taking care of one of life's essentials' and provide particularly welcome emphasis on securing services for the future.

- Companies placing their five-year delivery plans in the context of long-term strategies, the importance of delivering net zero and a process for approving multi-AMP projects at any time, not just at price reviews, have the potential to strengthen our industry's focus on the longer-term.
- A strong business plan incentive for encouraging companies to submit high-quality and ambitious business plans can also support PR24's welcome focus on the long-term. We think it is important that high-quality plans are sufficiently rewarded at PR24, which was not the case at PR19.
- A streamlined PR24 process for companies with strong track records of delivering for customers and demonstrating positive behaviours, will provide a strong incentive for companies to deliver above their PR19 final determinations for their customers.
- Removing the requirement for companies to have customer challenge groups (CCGs) is a sensible development in the context of greater research being undertaken on a comparable basis at a national level. We are already well advanced in developing an improved approach to obtaining challenge and assurance on our business plan, which we have been talking to your team about.
- We also agree with you that future pressures on capital maintenance costs could be different from the past due to, for example, achieving net zero and using more nature-based solutions. We are keen to work with you and the industry on collecting the evidence on these forward-looking costs to help identify the best whole-life solutions for customers and the environment.

There is one area of your consultation that we are very concerned about – changes to notional gearing. We profoundly disagree with the proposal to change the notional company gearing to 55%. We understand that you are concerned about companies' financeability and their credit ratings, but we think this is a counterproductive solution, which will lead to worse outcomes for customers. For example, if companies have to de-gear during AMP8 this will squeeze the investment that is needed to deliver net zero, tackle storm overflows and introduce more nature-based solutions, which goes against the wishes of our stakeholders and customers. It also seems perverse for the sector not to take advantage of very low interest rates and an increasing tax shield on behalf of our customers (which ultimately leads to lower bills). We think the proposal is likely to disproportionately affect the listed company model, which works so well for customers, because we cannot rearrange debt between HoldCo and MidCo. However, we also recognise your concerns and would like to work with you on alternative solutions for financeability without the damaging side effects of changing the notional company gearing assumption to 55%.

There are two additional areas of your consultation where we think there are opportunities for improvements.

First, there is compelling evidence that your outcomes framework has delivered vastly improved performance for customers and the environment since its introduction at PR14. We recognise that you want to reduce the number of performance commitments (PCs) and ODIs at PR24. We consider that bespoke ODIs, even if fewer in number, should remain a vital part of the outcomes framework because they allow companies to innovate with different service improvements. Where demonstrably successful, bespoke PCs can be rolled out to all companies at future reviews and will help to ensure that common PCs do not become static and unresponsive to changing customer needs. For ODIs to continue to be effective, enough revenue needs to be put at risk to encourage companies to improve their performance for customers and the environment.

Second, we note that at PR14 and PR19 there was a desire to take into account past performance when assessing forward-looking plans. However, this desire never translated into any specific advantage for companies that performed well. For PR24 we think Ofwat should look to innovate in this space, potentially creating a separate pathway for those companies that are doing the right thing. This could involve, for example, an early and accelerated process for considering their special cost claims and bespoke PCs. This could be based on a combination of environmental performance, service performance and behaviours. For example, while companies may not be able to deliver all their PCs, if they are seen to be increasing totex to address performance gaps then we think that is a behaviour that should be encouraged.

Overall, I feel motivated by your vision of a successful water sector in your consultation. We think there is much that is exciting and beneficial for customers and we look forward to working with you constructively over the next 18 months as you progress towards your final methodology.

Yours sincerely,

Shane Anderson
Director of Strategy and Regulation
Severn Trent Water

Response to questions

Chapter 2 – Ambitions for PR24

Q2.1: Do you agree that the themes we have suggested for PR24 are appropriate for England and for Wales?

We welcome your four themes of: focusing on the long-term; delivering greater environmental and social value; reflecting a clearer understanding of customers and communities; and driving improvements through efficiency and innovation. These themes align with our Purpose to 'take care of one of life's essentials'.

We support your focus on the long-term. We welcome your proposal that companies should place their five-year delivery plans in the context of long-term strategies. We also think there is merit in allowing major projects to be brought forward and funded at any time, not just at price reviews, to speed up the delivery of long-term benefits for customers and the environment.

Q2.2: Do you have comments on the considerations we've identified as relevant to the design of PR24?

We provide comments on your three design considerations below.

Providing more clarity about how you will conduct price reviews in the long term, while retaining the ability to adapt

We welcome your approach in this consultation of providing more clarity about how you will conduct price reviews in the long term.

In many cases, it is clearly beneficial for customers for you to provide more clarity on your long-term approach. For example, we welcome your continued commitments to using an outcomes-based approach and providing an allowed return on the RCV. The benefit of these commitments is that they give companies and investors the certainty to invest in assets that will deliver improved services for customers in the long term.

Streamlining the price review without losing the benefits of sophistication

At PR19 Ofwat approved allowances of £51bn and we understand that a certain level of sophistication in the price review process is likely to be needed to make sure these allowances deliver the best value for customers.

We think the main area where streamlining should be focused is on the PR24 data tables because the PR19 tables were voluminous and it was not clear that some tables and cells were used. We would welcome a ruthless focus on slimming down the data tables to the information that is essential for the price review.

We think it is important that you retain strong price review incentives for the core areas of:

- <u>business plan quality</u> – strong "fast track" incentives to encourage companies to submit high-quality and ambitious business plans.
- <u>operational performance</u> – a high-value ODI package to align the interests of investors with customers and to encourage company managements to focus on delivering service improvements.

- reducing costs – strong cost-sharing incentives to give companies the incentive to innovate and be cost efficient to reduce costs.
- efficient financing – we support incentives to encourage companies to reduce their financing costs.

To streamline the price review we support you moving some aspects of regulation outside the price review, for example the approval of large multi-AMP and multi-company investment schemes, which could speed up the delivery of long-term benefits for customers and the environment.

We also make some suggestions for simplification in this response such as:

- moving contestable developer services outside of the network plus price control, which will allow you to remove the developer services revenue adjustment (DSRA);
- having only one price control for water (covering water resources, raw water distribution, water treatment and treated water distribution) because you are not considering bilateral water markets for PR24; and
- dropping "*K*" from the revenue controls and setting them all as revenue controls. Ofwat already sets the retail and bioresources price control without using *K* factors.

Reflecting local and national diversity in the price review, while maximising the benefits of comparability across companies

We think your initial ideas for PR24 lean too far towards comparability and that it would be better to retain more scope for companies to reflect local and national diversity in PR24 for the benefits of customers and the environment.

We consider there should be more scope for company-specific customer engagement to make sure our business plan and the investments it contains are grounded in our customers' priorities. For example, national company research might not find bathing rivers to be a priority across England, but in a company with no coastline like Severn Trent our customers might be keen. We would like to give our customers the option to choose.

We consider there should be more scope for bespoke ODIs than the consultation implies. Bespoke ODIs, even if fewer in number, should remain a vital part of the outcomes framework because they allow companies to innovate with different service improvements. Where demonstrably successful, bespoke PCs can be rolled out to all companies at future reviews and will help to ensure that common PCs do not become static and unresponsive to changing customer needs.

Q2.3: How should we evaluate our progress, and how can we best develop or use appropriate metrics to do so?

We think your focus should be on service and cost improvements for customers and the environment.

We consider your main metrics of success should be companies' performance commitments (PCs) in the outcomes framework because that is what the price review incentivises companies to deliver. If you introduce different metrics to evaluate your progress it could cause confusion about what the industry is meant to be delivering and weaken the incentive for companies to deliver on their ODIs.

The more specific Ofwat is about what it wants to achieve from PR24 in terms of, for example, supply-demand, river quality or net zero, and the more it aligns the PCs and ODIs with those objectives, the easier it will be to evaluate progress.

Chapter 3 – How we regulate

Q3.1: How can we best regulate the water sector to deliver value for customers, communities and the environment? Do you agree, or have comments on, our suggestion to maintain our 'building block' approach based on outcomes, costs and risk and return?

We strongly support you maintaining the 'building block' approach to regulation based on outcomes, costs and risk and return.

We strongly welcome your commitment to retaining the **outcomes** framework in the long term. 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. 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.

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.

We comment on the specific design of the building blocks in our responses to the chapters on outcomes, cost assessment, risk and return and the design of price controls.

We consider that Ofwat-approved **multi-AMP investments** would 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. This would enable Ofwat to determine such schemes outside the price review, allowing time for a more detailed assessment of large investments and avoiding being constrained by the price review timetable. Ofwat could then check in on cost efficiency and customer protection at later review points, without having to revisit the approval of the project.

Q3.2: To what extent is greater co-ordination required across the sector? In what ways might we promote better co-ordination across companies and with other sectors, and how might this benefit customers?

We support a balance between co-ordination, competition and markets to deliver the best outcomes for customers and the environment.

We support strong business plan incentives for companies to submit high-quality and ambitious business plans, which requires there to be areas where companies can compete as well as cooperate

There has been a large increase in co-ordination since PR19 through the regional approach to water resources planning. We are not yet in a position where we can say whether that approach has worked, so it makes sense to review its merits over the next few years.

We think that catchment system operators have some merit in principle, provided water companies remain in charge of operating their own systems, but there are lots of practical issues we need to work through. The first step is WINEP reform and companies looking for nature-based solutions to problems like flooding and river quality. We support more pilots and data to provide more information on the merits of catchment system operators.

We look forward to engaging with you on the work you have commissioned from external advisors to examine the case for greater co-ordination in the development of water resources infrastructure when you share the findings in the autumn.

Chapter 4 – Increasing focus on the long term

Q4.1: What are your views on the need for greater focus in companies' regulatory business plans on how they will deliver for the long term?

We fully support your view that there is a need for greater focus on the long term – this requires action on all parts:

- Companies can and should do more to show how investments we make are delivering for the long term (and be held to account for maintaining any improvements) and take account of uncertainty; and
- Ofwat can do more to remove barriers and inconsistencies across the different strands of the methodology (which we touch on in the following questions).

We would welcome more integration between the long-term focus of the WRMPs and DWMPs with the regulatory business plan. A useful step to achieving this would be for the need for long-term schemes to be agreed in the WRMP and DWMP and the focus in the regulatory business plan and the price review being on the cost-efficient way of delivering these schemes.

Q4.2: What should long-term strategies seek to cover and what details should we expect companies to set out in business plans? Would common requirements would help us and other stakeholders to understand each company's approach?

There are pros and cons of standardising the contents of long-term strategies. Common requirements might make the strategies easier to compare and it might allow scoring or ranking of strategies which could be used to differentiate companies at PR24, which has merit. However, standardising the requirements could drive a more formulaic response, which risks missing an opportunity for innovation, creativity and ambition, which is something we want to encourage for the benefit of customers and the environment.

We think the purpose of a long-term strategy is to show the glide path and key steps that take us from current performance and resilience to the long-term ambition. But the reality is there is no single, definitive strategy that guarantees the most efficient and effective solution to sector wide and global challenges such as climate change, biodiversity or affordability. Allowing more flexibility for companies to describe their strategies and approach to adapting to uncertainty has the advantage of increasing the pool of ideas, which companies can share, discuss and then improve on.

While we are in favour allowing companies scope to innovate in their long-term strategies, we think to achieve some degree of commonality it might be reasonable to expect that all strategies should set out:

- How the company has used the existing planning frameworks and customer research to define its ambition and then the strategy for delivering that ambition.
- How the strategy will continue to deliver key service metrics (perhaps using the key common measures) in the face of **climate change**, **biodiversity** and **affordability**. Companies should then be allowed to include wider strategies if their plans include step-change improvements – eg

environmental ambition, but this should not be compulsory if the investment plan is one of largely maintaining the status quo.

- What monitoring the company will do to monitor if its strategy is effective.
- How the strategy will adapt to a changing world.

It's also the case that because the long-term strategies should encompass companies' WRMPs and DWMPs and those frameworks have common requirements this will lead to a degree of commonality between long-term strategies.

Q4.3: How would this build on the work completed in strategic planning frameworks?

The long-term strategies will build on the outputs of those planning frameworks, such as WRMPs and DWMPs, and show how we have used them to ensure we have system-wide strategies and to demonstrate either consistent assumptions across planning frameworks or to explain any deliberate differences.

Q4.4: How can we allow such strategies and plans to adapt to new information at future reviews while continuing to hold companies to account to deliver expected benefits into the future?

We consider that Ofwat-approved multi-AMP investments would allow for step-change service improvements for customers. They would enable Ofwat to determine such schemes outside the price review, allowing time for a more detailed assessment of large investments and avoiding being constrained by the price review timetable.

We think that setting out the criteria for assessing multi-AMP investment would be a really positive step by Ofwat that would ensure a fairer balance of risk and would encourage long-term investment by companies for the benefit of customers and the environment. For example, the first time a company makes a case it is fair and proper that it is exposed to the full suite of tests, but for each subsequent price review the scope of that review should be reduced to reviewing cost efficiency and reviewing the PC levels to ensure costs remain efficient and the targets remain challenging. The 'need' tests should not be reopened to give companies the certainty they need to invest for the long term.

There is also merit in reconsidering the role of deadbands for a small number of PCs that track long-term performance because that better reflects the reality that there is natural variation and uncertainty. For example, the weather is going to affect measures used to track resilience to climate change and it is not always possible to predict the precise relationship between intervention and performance when there are other variables at play. Directly linking investment and performance outcomes is particularly challenging for more innovative responses to long term challenges (such as exactly how far process emissions will be reduced through activities such as covering tanks or capturing gases).

In relation to companies' long-term strategies, companies update their WRMPs and DWMPs every five years and so there is a case for updating the long-term strategies every five years as well, although there might only be minor changes at some updates.

Q4.5: Would providing our views on comparable aspects of companies' plans in advance of business plan submission streamline the price review process?

We can see that there are advantages from having the key comparable aspects of the plans shared in advance of Business Plan submission. For example, having early views on base totex, common PC levels and common ODI rates, would give companies the opportunity to better inform any enhancements being put forward to meet long-term challenges.

In principle, we support Ofwat providing us with its views on comparable aspects of our business plans before we submit those plans. For this to give companies sufficient time to influence and shape our plans, we would need these early views at least 12 months before we submit our plans (ie October 2022). The risk with a shorter time period is that it would inevitably reduce the impact this information can have on company plans given the lead times involved in developing enhancement cases, developing bespoke PCs, carrying out customer engagement and assuring our submission, among other activities.

Q4.6: Should we adopt a collaborative approach to developing Welsh companies' plans at PR24? If so, how should we go about doing this?

Given the differences in the legislative and political landscape between England and Wales, we think it is logical for Ofwat to have differences in approach between these countries. Beyond that, we will leave it to Welsh companies to comment on the approach planned for Wales.

Q4.7: What are your views on how we could provide clarity over the long-term regulatory framework?

We strongly welcome your commitment to retaining the outcomes framework in the long term. The outcomes approach introduced at PR14 has led to a step-change improvement in service performance for customers since 2015 and will lead to more over the next 5 years.

We think a commitment to a **strong package of ODIs** at future price reviews will give companies the confidence to invest in service improvements knowing that they will be benefits from doing so over the long term. It will also align the interests of companies and their investors with those of customers and the environment.

Providing guidance on your intended approach to setting ODI rates in future price reviews could be helpful by underpinning your commitment to the outcomes framework, while providing more flexibility than fixing parameters for ODIs. The main issue is that companies need confidence that there will be a strong package of ODIs at future price reviews that justifies increased investment in services now.

We do not support the idea of making ODIs contingent on outcomes continuing to be delivered in future period. We do not think it is necessary because if a company allows its performance to slip it will incur higher ODI underperformance payments (or lower ODI outperformance payments) in those future years. It also blunts the one of the main benefits of the in-period ODIs, which is the immediacy of the financial incentive that provides a strong incentive for company managements to fund service improvements for customers and the environment.

Q4.8: Are there barriers to water companies changing how they deliver their core functions to deliver greater environmental and social value? How can we address any barriers?

We strongly support innovative solutions that deliver our core functions while providing greater environmental and social value. The green recovery investment that you recently approved for Severn Trent is a great example of fresh thinking in the water sector. Through the green recovery we will be delivering £566m (2017-18 prices) of investment in innovative schemes to create bathing rivers, build a flood-resilient community through nature-based solutions, reduce health risks from lead pipes, decarbonise water resources, accelerate environmental improvements and install smart meters. These schemes benefit our customers, move towards delivering your vision of the water sector and provide broader public value to our communities.

We look forward to sharing with you the information our innovative schemes will provide to inform your approach to environmental and social value at PR24.

Turning to barriers, we think these can be addressed. We set out below three key barriers we have faced that we can work together as a sector to overcome.

A first barrier is that, as you recognise in chapter 10, there are future cost pressures on maintaining operational resilience resulting from using alternative solutions to reduce carbon emissions, adjust to the impacts of climate change and move towards more nature-based solutions. These new approaches also provide more environmental and social value. We support adapting the price review process to allow efficient funding for these innovative solutions and the additional environmental and social benefits they provide. We set out more detail on how the price review could do this in our responses to the questions in Chapter 10.

The second barrier is that many of the alternative solutions to traditional solutions that have greater social or environmental benefits result in increased company risk. The main reasons why the risk is higher are:

- nature-based solutions don't always behave in exactly the same way when exposed to a resilience shock or stress. There is less understanding of how they behave in extreme conditions and are less controllable (for example due to the fact that the public can access them).
- They can take much longer to deliver (often requiring planning permission) or joined-up working with other organisations, so we have to manage risk to the delivery of our performance commitment during this time.

The third barrier is the existence of conflicting requirements that often prioritise local improvements over national. For example, reduced abstraction in one location has local environmental benefit but also a knock on impact of significant increase in carbon needed to replace the lost source with a new one.

Options to address this might include:

- More cross checking of the costs of the counterfactual – if customers are no worse off then it makes sense for water companies to contribute to solutions that offer wider benefits even if they aren't core functions.
- Closer working with the EA/ DWI to look at conflicting requirements and to agree PC targets.
- More guidance on how to value wider social or environmental benefits, such as whether it should all be monetised and whether all companies need to use the same value or whether we should ask customers.

Q4.9: Do you have any further suggestions for increasing the focus on the long term? If so, what are these?

We suggest Ofwat could consider developing whole-life cost (WLC) models in key areas, such as net zero and flood resilience, particularly where there is a degree of choice over the pace of investment.

We also consider there could be a benefit from requiring companies to provide a consistent description of their baseline position against key resilience challenges. All companies will vary on their current level of resilience for example on the path to net zero and more generally adapting to climate change risks such as flooding and this is important context when assessing future performance or investment plans.

We support Ofwat adopting multi-AMP investment vehicles, that can be agreed outside price reviews, that will give companies the certainty to invest in schemes that will deliver long-term benefits for customers and the environment.

Chapter 5 – Strengthening incentives

Q5.1: Should we undertake an initial assessment of plans at PR24? If so, what areas should we focus on in this assessment?

Our experience at PR19 was that the IAP was an important and valuable part of the process for recognising the ambition and quality of company plans. We felt that it was well-timed, particularly in the way it helped give fast-tracked companies the procedural benefits of early certainty. Off the back of this experience, we would be in favour of retaining the IAP for PR24, because it provides an incentive for water companies to deliver good-quality business plans for their customers.

In terms of the areas to focus on for the PR24 IAP, we think that the prime candidates are track record of service performance, social purpose, base costs (unless provided to companies before they submit their Business Plans), risk and return, and bespoke outcomes.

We would also suggest taking the assessment of large schemes out of the IAP and assessing these separately. As we could be moving to arrangements where it is possible to agree large schemes outside of the price review cycle, there's a strong logic for creating a separate process for these that is capable of standing on its own two-feet, and capable of being used as and when needed. A further logic for this is that large schemes tend to be highly bespoke and are much less comparable (if at all) across company plans. This would then allow for a more straightforward IAP process that is mainly focused on the areas of greatest commonality across the sector.

We also recognise that the need to protect the customer interest could mean that such an approach for all companies is a little too innovative at this stage. If that's the case, then our suggested approach could be reserved for those companies that have a strong track record of acting responsibly. For these companies, a more collaborative approach like that taken for the Green Recovery could be adopted

Q5.2: Should we consider adopting a more light touch approach at PR24 for companies with a strong track record of delivery during the PR19 price review period? If so, what factors should we consider in our assessment and why?

We strongly support a streamlined PR24 process for companies with strong track records of delivering for customers and demonstrating positive behaviours. It will provide a strong incentive for companies to deliver above their PR19 final determinations for their customers.

Over the last two price reviews, we've seen Ofwat place ever increasing importance on the need for companies to build strong track records. While increasing numbers of companies are now hearing this message, we think there's an opportunity to make sure such track records are able to truly shine though at the IAP. To make sure that those that do-the-right-thing get recognised, we suggest using a number of behaviour tests, such as:

- how well companies delivered on their performance commitments and environmental obligations from PR19;
- how companies responded to the PR19 final determination; and
- whether companies are investing sufficiently to address shortcomings.

Where companies are doing this then it's right that Ofwat supports such behaviour through extra procedural benefits, such as: (i) a different pathway for assessing investment cases (more collaborative like the successful green recovery process); and (ii) more scope for bespoke PCs, and an early and accelerated process for assessing them. Our expectation is that strong-track-record companies will be well-placed to identify newly emerging priorities for customers and therefore well-placed to propose innovative investment cases and new bespoke ODIs that could well evolve into common ODIs at PR29.

Q5.3: Should we streamline the price review by combining different steps in the process? If so, which of the three options outlined in this paper should we consider? And are there other options we can usefully consider?

For companies in England we support retaining the clear four-step assessment process from PR19 in Figure 5.1.

Our PR19 experience was that the initial assessment of plans (IAP) process played a crucial role in incentivising companies to produce high-quality Business Plans and making sure that companies were competing with each other on the content of those plans.

Alongside this, we found that having a clear staged process was enormously valuable for identifying highly complex areas and then giving the time and space for companies to land on practical solutions– a good example of this in action at PR19 was developer services, which proved to be more complex than the initial approach envisaged and saw us work well together to find a practical solution.

We also found that we benefited from Ofwat's constructive feedback at each stage of the process as this gave us good insight on how Ofwat's thinking was evolving, gave us the chance for valuable dialogue and ultimately helped us reach a PR19 outcome that delivered for our customers and the environment. We think a condensed process with fewer steps could lead to less dialogue and understanding between companies and the regulator that, in turn, could lead to poorer outcomes for customers and the environment.

Q5.4: Is a different approach needed for the initial business plan assessment for companies in England and in Wales?

Given the differences in the legislative and political landscape between England and Wales, we think it is logical for Ofwat to have differences in approach between these regions, including at the IAP.

Q5.5: What incentives should we provide for high quality plans at PR24? If we don't make use of early draft determinations, how else might we strengthen incentives to table high quality plans on first submission?

A strong business plan incentive for encouraging companies to submit high-quality and ambitious business plans will support PR24's welcome focus on the long-term. We think it is important that high quality plans are sufficiently rewarded at PR24, which was not the case at PR19.

At PR14, the fast track rewards were very strong, such as the higher returns earned by companies and the expectation that fast-tracked elements of plans would be accepted in-the-round and so left substantially unchanged for the draft determination – effectively a form of a do-no-harm clause.

At PR19, the fast-track rewards were somewhat more constrained and so provided only limited encouragement for companies to reveal the sort of information in their Business Plans that Ofwat could then use to challenge companies across the sector and drive a better deal for customers. Looking forward, we see a risk that, without stronger set of fast-track incentives at PR24, companies might decide that they'll be better off not seeking fast-track rewards with an ambitious business plan because of the smaller rewards seen at PR19 relative to the CMA's decision and relative to the rewards at PR14.

In our view, the solution to this problem is to increase the size of the fast-track rewards so that the incentive remains genuinely effective and making sure that there's an effective form the of the do-no-harm element seen at PR14.

Potential refinement

We've also had a look at how different regulators incentivise good-quality business plans. Off the back of this, there is one refinement to the plan incentives we think that is worth having a look at. The opportunity we see lies in splitting out the incentives for plan quality and for plan ambition so that these are encouraged and rewarded separately. This is an approach that the Essential Services Commission – the regulator in Victoria, Australian – adopted for water companies at its price review in 2018. Called the PREMO model[1], it successfully put in place different financial and procedural incentives for quality and ambition.

In adapting this concept in a way that could work for our sector, our idea is that quality becomes the sole deciding factor on whether a company is fast-tracked, slow-tracked or placed in significant scrutiny – with rewards provided in the form of meaningful RoRE up-lifts and maybe some procedural benefits as well. On the ambition side, we think plans could be graded across three levels – say: (i) core essentials, (ii) advanced and (iii) sector leading – with RoRE-based rewards to recognise ambition. This is even an area that companies could self-assess in the first instance, with the ambition rewards then dialled back if Ofwat has to revise the self-assessed score – giving companies real encouragement to self-assess accurately in the first place.

With the current single-incentive approach, we see that there's a risk that fast-tracking becomes restricted to just those companies that propose plans close to base expenditure – in other words plans that are very much business-as-usual. With the need for the sector to face into the climate challenge – both in terms of climate resilience and decarbonising our own emissions – restoring our natural

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[1] https://www.esc.vic.gov.au/sites/default/files/documents/Water-Pricing-Framework-and-Approach-Final-Paper-Oct-2016.pdf

habitats and population growth we see a growing risk that company plans will require a level of ambition that could rule out fast track if the approach isn't fittingly tuned-up.

We see that this two-pronged approach has the potential to bring other benefits. These include driving home the message that quality is important whatever the level of ambition, while allowing companies to match the ambition of their plans with customer priorities, preferences and affordability constraints. This openness to different levels of ambition is likely to be particularly helpful given just how much affordability and socio-economic challenges can differ from one company to the next.

Q5.6: How might we set cost sharing rates at PR24? Should we consider an approach based on our ability to monitor companies' asset health status?

We think that the current 50:50 totex sharing approach for Severn Trent is working well. It provides a very simple and balanced approach that successfully manages downside risk while making sure that we have strong incentives to find and deliver cost efficiencies.

Q5.7: Which areas should we be considering targeted challenges for at PR24, and why?

Our experience is that targeted challenges absorb significant resources and management focus. If Ofwat plans to introduce more targeted challenges at PR24, then we suggest it should consult with customers to see whether they support them and in which areas they'd like to see them applied.

If we are to have new targeted challenges at PR24, especially if they are to come on top of the existing one for leakage, then it's absolutely critical to make sure companies are funded to deliver the expected improvements in performance. The reality is that targeted challenges absorb significant resources and management focus, so without the right levels of funding the challenges are likely to unduly strain company resources, overstretch management focus and impact the sector's overall ability to keep delivering for customers.

For us, the other key takeaway from the leakage challenge is that the targeted challenge must relate to an area under the direct control of the company. Sewer overflows might therefore be suitable, if improvements are funded and there's recognition that water companies alone do not control river water quality, with agriculture and road surface run-off also having large impacts.

An example of where a targeted challenge would not be appropriate is PCC, because companies would need to persuade and encourage another party (in this case household customers) to take action. In other words, an area where companies are one-step away from the apex of the issue. The impact of covid-19 has shown that despite the very best efforts of companies, external factors can drive very different outcomes that are far beyond the control of companies – at the very least in the short-run. If the targeted challenge were to be about improving non-household efficiency of use, this could prove even trickier as companies are effectively two-steps away from the apex. Not only would they be trying to persuade customers to become more efficient, they would in practice be trying to persuade someone else's customers.

Q5.8: Should we use innovation specific incentive mechanisms at PR24? If so what would these be, and what would they add in addition to the other mechanisms outlined in this chapter?

We see innovation as having an important role in transforming services and addressing complex environmental challenges in a sustainable and cost-effective way. Even with the innovation incentives put in place at PR19 getting off to a very good start, we agree that it's too soon to judge overall success and that there's still space to learn lessons that can help innovation incentive mechanisms to evolve for PR24 and beyond. Overall, we support the use of use innovation-specific incentive mechanisms at PR24 and that these should look to build on and learn lessons from what was done at PR19.

If we look across at the energy sector, we see that there's potential to adopt a version of Ofgem's stratified approach. In addition to a central strategically-focused innovation fund that is similar to our sector's fund, Ofgem also provides companies with their own dedicated innovation pot to fund smaller technical, commercial, or operational projects directly related to a company's regulated business. The advantage of this approach is that it provides more fleet-footed and more innovation-focused companies with an extra opportunity to harness innovation for the benefit of customers.

We want to emphasise that the approach Ofwat took to the green recovery successfully encouraged us to submit innovative proposals on bathing rivers, net-zero water resources, replacing lead supply pipes, flood-resilient communities, smart metering and environmental improvements. We think that if you adopt a similarly welcoming approach to innovative investment projects at PR24, you could stimulate a large extra dollop of innovation on top of that created by your specific innovation mechanisms.

Q5.9: In what ways might we promote the themes of EBR through PR24?

We think that an *ex-post* approach to EBR is likely to prove the best way forwards here. The benefit of such an approach is that it gives freedom to companies to decide how best to more forwards as ethical businesses, giving them space to come up with lots of ideas and innovative ways of doing this. Companies could then be judged by their track record in this area – an assessment that could become part of the wider track-record assessment used to decide whether or not to take a lighter-touch approach for the price review.

Chapter 6 – Reflecting customers' preferences

Q6.1: What are your views on the merits of our proposals for a collaborative approach to standardised and/or nationwide customer research to inform company business plans and our determinations?

We support the principle of a collaborative approach to some of the research for the price review. In common with Ofwat we have also noted with some concern the large variances between companies results from Willingness to Pay (WtP) surveys, that can not necessarily be put down to regional variation in customer preferences. A collaborative nationwide or more standardised approach would allow us to reliably identify true regional variations and get a more consistent picture of customer preferences.

Collaborative research could also help this industry be proportionate in its engagement with customers – with timely, focused research on the issues that are material and meaningful, and that customers have genuine scope to influence.

As we explain in our response to Q6.2, there are still areas where we think a company-specific approach would remain most appropriate.

Q6.2: Do you have any suggestions for how we best implement the collaborative approach to customer research for the price review?

In order for a collaborative approach to be successful we believe we need to rapidly develop a common understanding of:

- what is included in the common research (and what companies will need to conduct their own local research on);
- the purpose of the research (what we will be using the outputs for in the business plans – this is critical for the research design);
- who undertakes the research and whether it's national, regional or local;
- appropriate governance, such that each company has the opportunity to influence the research design;
- the role of assurance and challenge (see Question 6.4); and
- timescales, so that companies know when results will be available to integrate into their business planning processes.

Depending on what the research is being used for we see a benefit in either a nationwide approach or developing a standardised methodology that companies follow when commissioning their own research. We have set out our thoughts in the table below.

	Method	Why	Example
a) National	Nationwide approach/sample	Nationwide issue where local circumstances/preferences are not material to decision making	Setting a national standard or ambition, for example a Water Strategy for Wales
b) National	Nationwide approach – company specific sample OR standardised approach – company implemented	Common areas where comparability is important, but regional experience (bills, service etc) will shape preferences	Common PCs and incentive rates Acceptability
c) Regional	As above or collaborative insight sharing	Stakeholders in a common problem (or opportunity)	Regional water resources planning
d) Localised	Company specific	Company and/or customer specific circumstances can make a material difference to decisions. Comparability of results is less important	Bespoke PCs, investment proposals – (ambition, scope, pace, approach) and affordability & vulnerability

At the workshop on 28 June Ofwat presented a number of topics that could form part of a collaborative approach:

- Overall current, and long-term priorities;
- Policy – explore whether customers want to inform our decisions;
- Valuations of service improvement / deterioration and other PC/ODI parameters;
- Affordability concerns; and
- Plan acceptability.

We agree with Ofwat that understanding the end use of the research is key to determining the scope of the collaborative approach.

For example, if the aim of "Overall current and long-term priorities" is to inform the list of common PCs we feel this could be done by analysis and triangulation of existing, including PR19, insight. We think long-term priorities would be best covered by local research, and indeed companies might have already have carried out research on the longer term as part of insight projects linked to their Water Resources Management Plans, Drainage and Wastewater Management Plans and their long-term strategies.

Whilst we accept that customers might have a view on some areas of policy (when care is taken to explain them in a simple and engaging way) we need to ensure that the research is meaningful to customers and that the cost is proportionate. CCW's report *Engaging water customers for better consumer and business outcomes* finds that some areas, such as regulatory metrics and business plan inputs that are so technical they require expertise to understand, are least appropriate areas for research. A cost-effective approach could be to triangulate the research companies have already undertaken on policy aspects such as ODI design, and to consider whether those views are likely to have changed over time.

For valuation research we see value in a nationwide approach, with a robust sample (potentially giving companies the opportunity to boost the sample) for each company. We believe the variability in results would be reduced using a common approach, and common service metrics and descriptions, but will retain company-specific bill levels and current service levels. It might be beneficial if some minor survey customisation / additional questions can be included so companies can get added value from the research, without compromising the comparability of the results. This might be particularly important for smaller companies, who might have fewer opportunities to run statistically representative quantitative research with customers.

It will be important to be clear on the end use for the research to determine the optimal timing and appropriate research design. For example, companies have typically done a large scale piece of stated preference willingness to pay research which is used to determine values for cost benefit analysis (for enhancement business cases) as well as to help determine ODI rates (alongside other data sources, and through triangulation). This can also be accompanied by second stage research, for example to understand customer views on different severities of flooding incidents or duration of an interruption to water supply. Because cost benefit analysis can make the difference as to whether an investment proposal or particular option is put forward or not, companies will typically undertake WtP research fairly early on in the business plan timeline in order to get these valuations to feed into the development of investment proposals. Early clarity will be needed on what is included in the nationwide collaborative research so companies can identify any gaps and undertake further local research. There is a risk that without early clarity there could be inefficiency or difficulties comparing nationwide research with single issue local valuation research.

If the aim of the collaborative research is purely to determine ODI rates a simpler approach could be considered, such as a top-down "allocation" of a reward / penalty pot to different elements of service. This could potentially be more meaningful for customers and avoid the apparent contradiction, highlighted in the consultation document, of customers supporting improvements in service but not outperformance incentives.

Overall affordability and acceptability of the business plan is typically the last piece of research that companies undertake, once the plan and bill levels are finalised. This requires the plan to be communicated to customers in an accessible way. It may be tricky to make questions about the affordability of future bill profiles meaningful for customers, particularly when components such as inflation and ODI performance are being forecast, and many things could affect customers' circumstances over time. If such research has to be undertaken prior to submission we see value in following a standardised methodology, thus giving companies the flexibility to commission the research at their own timing, or undertake multiple "rounds" as their plan is finalised.

A further important consideration given the above, is how national research will be governed. For this governance to be effective, it needs to consider:

- which party(ies) will be making material decisions on the basis of its findings; and
- who will be held to account or impacted if it is not successful.

In both instances, it is Ofwat (who will be making determinations) and companies (who will be making decisions about how they deliver against their obligations) who will be the principal users of this research – it is therefore vital that they have the opportunity to be meaningfully involved in its development.

That is not to say that other stakeholders and research experts should not be involved in challenging and scrutinising research development – indeed this is likely to be important to ensure good research design and wider confidence in its quality – but companies should not play a secondary role in decision making.

Q6.3: Are there aspects of negotiated settlements that could be reflected in our price review framework?

Over the last three price reviews, there have been a range of industry debates about how customers can be best represented in price reviews. This could include, for example, introducing negotiated settlements as are used in the industry in Scotland.

Rather than a negotiated settlement style approach, Ofwat's framework has instead placed the onus on effective insight (research, data-led insight and engagement) and a clear line of sight of how it has been acted on in planning, to ensure customers are represented in price setting.

While there are some merits to negotiated-style approaches, we believe Ofwat's approach to date has been effective, and works well in the wider regulatory and policy contexts in England and Wales – and offers the flexibility to be adapted where there are differences between England and Wales.

Q6.4: What are your views on our proposals for customer challenge of business plans and assurance of customer engagement?

We are very supportive of Ofwat's proposals to: i) not mandate the use of CCGs; and ii) move to a guidance-led approach to ensuring companies' business plans undergo appropriate assurance and challenge.

Our CCG, the Water Forum, has helped us to create better plans for our customers over successive price reviews – but Ofwat's approach to regulation is evolving, and it is important that the method of challenge evolves with it to remain effective.

We believe there are good grounds for moving to a guidance-led approach:

The changing role of company-bespoke (localised) research in price reviews also changes the need for assurance and challenge

As explained above, we understand the rationale for making customer research more comparable in some areas of business planning. PR14 introduced a large amount of company autonomy to undertake our own customer research and respond to it in our plans – but at the cost of comparability. Over successive reviews, Ofwat has sought to re-introduce greater comparability and PR24 continues this trend.

	PR14 *Local, bespoke*	PR19	PR24 *National, comparable*
PCs & ODIs	All bespoke	Some common	'Most' common
Investment	Statutory/discretionary	Statutory/discretionary	'Greater proportion' statutory
Customer insight	All company-led	All company-led	Industry-led: WtP, common ODIs, acceptability
CCG role	Broad, company-defined	Defined in Ofwat 'aide memoir'	Not mandated

The scope for company-specific research to shape plans at PR24 contrasts with that at PR14 when CCGs were created – the higher degree of autonomy for companies to undertake their own research at a time when our research capability was arguably less mature, drove the need for greater oversight.

As there will be less scope for company-led research to influence decision making in key areas (like common PCs and ODIs) at PR24 than when CCGs were created for PR14, it is sensible to also review the role for assurance and challenge.

The role of CCGs had become complex

One of the key challenges that CCGs face is the extent to which they can offer independent assurance to Ofwat, while also offering constructive challenge to companies (which often requires close working to be most effective). In practice, the two are complementary but different activities, and that in future a clearer distinction could be made between them (see below). This would allow companies to engage CCG-type expertise (whether as a formally constituted group or through a range of means) to constructively challenge and advise on their plans, without having to navigate the risk of 'capture' as CCGs at previous price reviews did.

We now have the opportunity to refocus assurance and challenge. We believe there is merit in first starting with where there is scope for localised customer insight to drive decisions in Ofwat's evolved approach, and then for companies to build a method of challenge that works in this context. This will negate the risk of inviting challenge at a company level where it cannot have an impact on final decision making, and which would be frustrating for all parties.

A guidance-led approach would provide companies with the flexibility to design assurance and challenge approaches that work for their stakeholders and their plan

We remain very supportive of inviting challenge on the development of our plan – we do not want to create it in a silo and very much value the contribution that our stakeholders make. We also want to ensure that we undertake effective, risk-based assurance on our plan so that all stakeholders can have confidence that it is high quality. A guidance-led approach would give companies the flexibility to do this in a way that works best for their local circumstances, their stakeholders' preferences and within their assurance and governance frameworks. This could include retaining a CCG, an evolution of it, or exploring a different approach.

We believe this guidance should:

Distinguish between assurance, challenge and consultation

The change in approach for PR24 is an opportunity to go back to first principles and think about assurance, challenge and stakeholder insight as separate (but not necessarily mutually exclusive) activities that all have a role in making business plans, and the outcomes they aim to deliver, better.

The table below illustrates that the aims of each can be quite different, and seek to inform plans in different ways.

Assurance *Independent scrutiny to highlight risks (accurate, complete, usable)*	**Challenge** *Constructive expert challenge to deliver better outcomes*	**Consultation** *Learning from expertise of others to understand best practice and find opportunities*
Will statutory outcomes be met?	Are we taking the best approach to meeting statutory outcomes?	How can we best meet the needs of our more vulnerable customers?
Was the method and delivery (of higher risk) research appropriate?	What's the right research method to use, how could it be improved?	What are the priorities of other stakeholders in our region?
Have (higher risk) insight findings been appropriately interpreted (and triangulated)?	Have research outcomes been appropriately interpretated?	Where are there opportunities for partnership working, and how can we best exploit them?
Has the company accounted for how and where insight findings have been used in its plan?	Are we exploiting the most potential from the insight we have? What other insight is available that we should draw from?	
Is there sufficient evidence of a 'best value' plan? (WRMP requirement)	Are we exploiting the most opportunities from our investment proposals?	
Have bespoke PCs and ODIs been designed consistently with Ofwat's methodology?	How can bespoke PCs and ODIs be defined and designed to deliver the best outcomes?	

Allow companies flexibility to determine the best method of engaging assurance, challenge and consultation at a local level

As well as assurance, challenge and consultation having different aims, they also require different capabilities from different stakeholders. These stakeholders in turn are likely to have different preferences about how they are engaged. For example, we use contractual terms with agreed scopes or processes for assurance providers, which would not be appropriate for stakeholders providing challenge.

This distinction is illustrated below.

What is the ask?	**Assurance** *Independent scrutiny to highlight risks (accurate, complete, usable)*	**Challenge** *Constructive expert challenge to deliver better plans*	**Consultation** *Learning from expertise of others to understand best practice and find opportunities*
Who can provide it?	Independent experts	Core industry stakeholders or specialists (eg customer research)	Experts or specialists in relevant areas (but not necessarily industry specific, eg local authorities)
What is the best way to engage them?	Audit, formal process or methodological reviews	Panels/Groups, 1:1 meetings	Workshops, consultations, 1:1 meetings, attending existing groups etc
Who is the recipient? **National:** **Local:**	Ofwat, regulators, companies Ofwat (via Companies' Boards)	Ofwat Companies	Ofwat Companies

A further dynamic any future frameworks need to consider is how to distinguish between the 'providers' and 'recipients' of assurance and challenge, which could be different depending on whether customer research is being undertake at a national or localised level. For example, for research undertaken at a national level, where all companies, Ofwat (and others) have a stake or have taken part in the design of research, all are likely to require confidence that it is of a high quality.

Work within companies' overall assurance frameworks for business planning

The PR14 and PR19 arrangement for CCGs to provide assurance directly to Ofwat contrasts with the model of assurance used for other areas of business planning, where company Boards provide assurance to Ofwat, on the basis of their own well-established, risk-based assurance frameworks.

The quality and use of localised customer insight in business planning could also be embedded into these processes, which negates the need for separate CCG assurance. For example, companies should be able to evidence to their Board and assurance providers that they have sought, and responded to, appropriate challenge on their plan (be it through a CCG or alternative), as well as using consultation and engagement to garner the views of a wider group of stakeholders.

Q6.5: What are your views on whether we should develop minimum standards or provide guidance in other areas?

The consultation identifies three areas where Ofwat propose to develop minimum standards or provide guidance:

- **high quality research**;
- **independent customer challenge to companies**, with a focus on company delivery of commitments made to customers;
- **independent assurance** of i) the quality of companies' local customer engagement for the price review and ii) use of the results of local engagement and the proposed nationwide research in price review submissions.

We have provided comments on each in turn.

High quality research

We strongly agree that customer research should follow best practice and lead to a meaningful understanding of what is important to all customers and stakeholders. This means customer research should be high quality, that the methodology and sample must be appropriate for the research objectives and that participants understand the questions asked. We also concur that it's important to monitor customer views continually and not just at price reviews.

Companies having access to the professional expertise of members of the Market Research Society (MRS) – either through their own teams or the agencies they use – should be a first step to providing confidence in the quality of their research. The MRS is the UK professional body for research, insight and analytics. As the industry regulator, it promotes the highest professional standards, not just ethical standards, via the very comprehensive MRS Code of Conduct, to which all members must adhere.

We agree that research findings should always be accompanied by clear and detailed information on the methodology for the research. Further to this, if there are areas of research where Ofwat has a view on the maximum margin of error acceptable for quantitative research and any sample quotas that should be set to ensure representativeness and comparability between companies' findings, then this could be incorporated into the guidance.

We also support the objective for research to be free of bias; transparency about the methodology used should help to achieve this, but we would welcome guidance if Ofwat had further expectations for how companies could evidence this.

We can see the opportunities created by companies sharing their research findings. However, we think it's important to have clarity on which projects there would be most benefit in sharing, and at which stage of the process.

Companies are continuously undertaking research projects which vary in their size and significance (for example, they could range from testing communications design through to willingness to pay). Therefore, we think there should be some proportionality around which research is published – ie, where it underpins a material decision or there is a common interest (like regional planning) – rather than a blanket requirement (a series of principles guiding publication that are consistent with the aim of driving innovation and collaboration could help in this regard).

We would welcome Ofwat's views on how its appraisal of the quality of companies' customer engagement at PR24 will balance innovative ideas versus collaborative approaches. There could be tension between companies competing to have the best customer engagement at PR24 and publishing all their research as part of a collaborative approach.

Given this potential for competition (which has historically helped to drive forward improvements) a potential risk with requiring companies to publish research is that it unintentionally incentivises companies to delay important research projects, pending the publication of other companies' research. It is also important that it does not encourage companies to be risk averse, disincentivising asking innovative questions and using innovative methodologies – which would run counter to the aim of sharing.

Independent customer challenge to companies (with a focus on delivery)

There are already well-established and effective arrangements in place to drive company delivery of our commitments to customers:

- **Governance arrangements** – a core role of non-executive Board members is to challenge executive teams on the delivery of commitments. Our CCG did not seek to replicate this role, but instead asked our Audit Committee to report to it how it had scrutinised performance and reporting.
- **Strong financial delivery incentives** – ODIs have successfully aligned investor and management incentives with better outcomes for customers and the environment. This is further strengthened by replicating these incentives in our employee bonus scheme.
- **Strong reputational incentives** – transparent reporting of annual performance (or more frequently by some companies) and our own reporting to the City as a listed company creates strong reputational incentives to perform. Ofwat also publishes an annual performance report comparing company performance on service delivery, which acts as a strong reputational incentive to improve performance.
- **Cultural incentives** – performance commitments and the need to meet statutory obligations are well embedded within water companies, but many companies also have purpose-driven cultures where employees are highly motivated to deliver more for customers and the environment.
- **Regulatory oversight** – Ofwat, the EA, the DWI and CCW monitor our delivery performance and challenge us. For example, the EA's annual environmental assessment with companies being awarded up to 4 stars involves a large reputational incentive for companies to improve their performance and involves EA scrutiny and challenge on our performance.

We would therefore question the need for any further requirement for independent challenge of company delivery of commitments made to customers that goes beyond these arrangements already in place – particularly for well performing companies. This wasn't a requirement for companies or CCGs at PR19, only an option, as explained in the aide memoire for CCGs[2].

Requiring further challenge of company delivery of commitments – which goes over and above this – risks creating duplication, distracts management from delivery to focus on reporting (which can be resource intensive, especially where additional assurance on data is required and more frequently than at present) and risks not adding any further value for customers over these arrangements.

Independent assurance

As explained above, we believe there is merit in making more of a distinction between the expert challenge and advice that is provided by stakeholders (for example, of the type currently provided by CCGs) and other forms of assurance (for example, expert peer review of willingness to pay or companies' third-line assurance providers). Both have an important role in companies' overall assurance frameworks, and we should be able to evidence that they have taken place in support of our business plan submissions.

[2] https://www.ofwat.gov.uk/wp-content/uploads/2018/03/Aide-Memoire-for-Customer-Challenge-Groups.pdf, "First, many CCGs are involved in reviewing and challenging companies' on-going performance, including their Annual Performance Report." (page 2)

Any guidance for assurance should follow similar principles where Ofwat has previously set out its expectations for assurance in other areas of business planning. This includes ensuring assurance is risk-based – taking into account the complexity of the research and whether the outcome could have a material impact on customers. In many cases, we expect the higher risk research (eg, willingness to pay) to be undertaken centrally and an appropriate approach to assurance should be developed to provide all stakeholders with confidence in the outcome. We provide more detail on our views on the contents of the guidance on independent assurance, and the types of questions it could consider, in the annex to this response).

Q6.6: How well does our proposed approach to customer engagement take appropriate account of the different regulatory frameworks in England and Wales?

Ofwat's approach, particularly as it is guidance-led, offers sufficient flexibility to work in the different regulatory frameworks between England and Wales and also takes into account different policy and stakeholder contexts.

Chapter 7 – Planning together for PR24

Q7.1: How can we ensure that companies bring together the outputs of the strategic planning frameworks in the most coherent and effective way for business plans?

We would welcome more integration between the long-term focus of the WRMPs and DWMPs with the regulatory business plan. A useful step to achieving this would be for the need for long-term schemes to be agreed in the WRMP and DWMP and the focus in the regulatory business plan and the price review being on the cost-efficient way of delivering these schemes.

Q7.2: What are your views of our thinking on our and companies' roles in engaging with other regulators between business plan submission and our issuing of the final determinations?

We consider that it is a company's job to engage with all our regulators as we develop our plan to make sure our proposals are delivering our statutory requirements and also to understand their views on where we are going beyond our statutory requirements to deliver additional benefits supported by our customers. While it is a matter for Ofwat's discretion we would support you engaging with the other regulators after we have submitted our business plan to inform your price review analysis.

We think there is a lot to be learnt from the recent green recovery process. The green recovery involved Ofwat and the other regulators assessing innovative schemes with uncertainties and choices. We found having an early and open dialogue very useful with Ofwat and the other regulators to understand concerns early on, discuss difficult trade-offs openly, enabling us to address them and make sure the innovative schemes were not dropped for a lack of understanding.

Q7.3: How could we best involve a 'PR24 Challenge Panel' in the price review process to help ensure that our decisions best reflect the interests of customers, communities and the environment?

As we explained in our response to Q6.4 above, we have found focused challenge of our decision making in areas that are material to customers, valuable. We also believe that transparency and offering others the opportunity to scrutinise and challenge decisions more generally are crucial tenets of price reviews.

Ultimately, it should be at Ofwat's discretion as to how it engages this challenge – particularly if it chooses to do so before draft determinations – but we suggest the terms on which challenge is being requested and how Ofwat would propose to respond, should be transparent to everyone. We also suggest that Ofwat might want to engage with Ofgem on its lessons learned from its RIIO-2 Challenge Panel.

Chapter 8 – Design and implementation of price controls

Q8.1: Do you agree with, or have any comments on, our general approach to the design and implementation of controls, ie to retain separate controls with the same broad structure as at PR19, but with improvements to our implementation?

We support separate price controls where they provide benefits to customers that are greater than the additional cost and complexity they bring.

You could simplify the price controls by having only one price control for water (covering water resources, raw water distribution, water treatment and treated water distribution) because you are not considering bilateral water markets for PR24

You could simplify the price controls further by dropping the "K" factor from the revenue controls and setting them all as revenue controls. Ofwat already sets the retail and bioresources price control without using *K* factors.

Q8.2: Do you agree with, or have any comments on, our proposals for specific parts of the value chain, ie for water resources, developer services, residential retail and business retail in Wales?

We discuss the four parts of the value chain relevant to Severn Trent in each sub-section below: water resources, bioresources, developer services and residential retail.

Water resources

We support RAPID's work to accelerate the development of new strategic infrastructure. We are engaging with and supporting RAPID's three working groups on strategic resource options.

In relation to the proposals on the water resources price control, the best approach depends on what Ofwat wants to achieve. We note that the consultation document says "After consulting stakeholders we have concluded that interest in bilateral markets is currently limited. In PR24 we intend to prioritise work likely to yield the best outcomes for customers." (page 76). To maintain the scope for bilateral markets in the future Ofwat might not want to combine the potentially competitive (water resources) and natural monopoly (raw water distribution and water treatment) parts of the value chain in the same price control.

If Ofwat is concerned about the effectiveness of cost models and companies not focussing sufficiently on reducing total costs where there are synergies across the price controls Ofwat might want to consider moving back to one water price control for PR24 (covering water resources, raw water distribution, water treatment and treated water distribution). Ofwat could still use the time until PR29 to better define a price control that fits with your long-term ambitions for the sector.

Our main concern with the proposed change to the scope of the price control is that there is no explanation of what the regulatory protection for the RCV in the new price control would be. We would like to understand more about the proposed approach through engagement over the coming months.

On the bottom of page 76 the consultation document mentions additional interventions if water companies show insufficient ambition to developing water resources. We think additional interventions are unnecessary because water companies have strong incentives to develop water resources, which are a fundamental part of their business.

Bioresources

We support the development of an effective market for bioresources. An important point to take account of is that the market is developing at a pace that reflects the lags in investment decisions. For example, the bioresources assets that are being commissioned now reflect investment decisions taken before the development of the bioresources market.

As set out in the Jacobs report, the main opportunities for market development appear to be in:

- the provision of additional capacity, through collaboration or a bidding approach – this is dependent on when and where additional capacity is required;
- co-digestion, which requires regulatory change; and
- headroom trades at incremental cost – this may require additional guidance on when incremental pricing is appropriate and is limited by available capacity and transport distances.

We support the development of the framework to promote these opportunities. However, they are limited by the need for additional capacity and the timing of regulatory change on co-digestion.

On the specific proposals we can see benefits from establishing bidding market arrangements, undertaking better targeted cost assessment, encouraging greater sector collaboration and ensuring more joined-up pro-market outcomes. We consider that these proposals would encourage the forms of competition set out above.

We have concerns over Option 2 (in the Review of the Bioresources Market – consultation) on moving towards the benchmarking of average revenue.

Our first concern is that because enhancement costs are lumpy and vary between companies it will be difficult to draw meaningful comparisons between them without considering enhancement expenditure separately, so Option 2 does not really offer an advantage over Option 1 in this respect.

Secondly, the consultation acknowledges that although Option 2 would move the sector closer to a “gate fee” approach used in the wider waste sector it is still fundamentally different because it would be based on dry tonnes rather than wet tonnes.

Thirdly, costs, and therefore average revenue, differ between regions depending on a number of factors such as population density and availability of agricultural land. These factors would need to be taken into account in benchmarking.

Fourthly, Ofwat acknowledges the proposed approach could introduce an excessive risk of asset stranding (page 20 of the Review of the Bioresources Market – consultation). This could undermine investment incentives for companies and discourage innovative approaches. If Ofwat does pursue option 2 we will want to engage constructively on the options for reducing the risk of stranding.

An important caveat is that it’s not clear how moving to the benchmarking of average revenue would lead to asset stranding. On its own, this would be unlikely to create asset stranding, because it would require substantial changes in sludge volumes for this to happen. We consider there are three potential forms of stranding:

- If what is envisaged is Network+ being a customer, procuring sludge treatment services based on prices set at lowest average cost, then this could lead to asset stranding. This option is not advocated in the Jacobs report. It creates difficulties in determining whether the commitment to protect pre-2020 RCV is delivered, because assets are not specifically identified as being pre or post 2020. Glidepaths for average revenue would not deliver on the commitment to protect pre-2020 RCV because if volume reduces due to competition then the overall return on pre-2020 RCV would not be achieved.
- If what is meant is not that actual assets are stranded but that the average revenue assessment is insufficient to cover pre-2020 RCV run-off and return, then we agree that this would be a risk. A floor or glidepath on average revenue would not in itself remove this issue. There would need to be some apportionment of the average revenue to pre-2020 RCV return and run-off, to assess whether it is fully covered. This would be a complex and difficult process.
- If what is meant is that for any investment there would be a risk that return and depreciation would not be covered in future, then we also agree that this could be a risk. The Jacobs report and Ofwat's consultation refer to the possibility of long-term contracts, which would address this risk and encourage investment and competitive entry. The proposed approach would conflict with these objectives, by putting future returns at excessive risk.

Developer services

We think there are more options than you have discussed in section 8.2.3 for the regulation of developer services. We have summarised them in the table below. As you recognise in the consultation you can treat site-specific (contestable) and network reinforcement (non-contestable) costs for developer services differently.

Type of regulation for developer services	Site-specific activities (contestable)	Network reinforcement (non-contestable)
1) Subject to the network plus price control and in the base econometric models.	Current approach CEPA option 1	Current approach CEPA option 1 CEPA option 2 Our proposal
2) Have their own separate developer services price control and in the base econometric models.	Ofwat considering	
3) Remains appointed income, but not covered by a price control.		
4) Excluded from the price control, regulated through charging rules and subject to a capped regulated margin, subject to their being sufficient competition in the regional market.	CEPA option 2	
5) Excluded from the price control and regulated through charging rules. No requirement that there be sufficient competition in the regional market because the charging rules provide sufficient protection.	Our proposal	

We consider Option 2 (a separate developer services price control and costs in the base econometric models) is unworkable. This is because water companies would be prevented by the charging rules from varying their prices to developers, which would stop companies from being able to recover their allowed revenue or forcing them to over-recover compared with their allowed revenue.

We think there are two separate questions you should consider in relation developer services:

- Is there sufficient competition for a market to determine prices?
- Where there is not sufficient competition, does the single till help to protect developers and other customers?

If the answer to the first question is yes, then this is an argument for removing the contestable element of costs from Ofwat's price controls and econometric models, because we should be able to rely on the market to determine the correct prices (with a reasonable backstop of Ofwat's charging rules).

Where the answer is "no", Ofwat would consider the second question. For the services that are not currently open to third parties, then it is reasonable for Ofwat to apply an efficiency challenge to company costs – ie, keep them within econometric models. It does not follow that the approach to these services should remain the same. We do not think the "single till" is necessary to protect developers from excessive pricing because Ofwat's charging rules already require prices to reflect costs, and the costs have already been subject to efficiency challenge. The effect of the "single till" for these services is to pass a risk relating to variances in capital contributions through the RFI. Because developer charges must match costs, their charges cannot be varied so this risk falls on our customers.

It is this risk – created by the "single till" – which is imperfectly corrected through the DSRA. Many (or perhaps most) of the variance in capital contributions within period relate to variations in the cost of the works that developers require and the proportion of these that companies can recover in line with the rules.

Severn Trent's region is one where there is considerable competition for developer services, but we do not think there is a need for a different regulatory approach to contestable developer services in regions where competition in developer services is well developed. This is because the Ofwat charging rules provide back-stop protection for developers whether there is competition or not. Relying on the charging rules and excluding developer services revenue from the price controls (and treating them as appointed income) will make it easier for competition to increase in all regions. We recognise that this will require clear cost allocation rules for developer services.

If Ofwat decides to include a margin for the contestable element of these services, it will be important to consider what effect it is trying to drive with this change. Companies do not currently view developer services as a profit centre – their interest is purely in recovering costs. Self-Lay Providers and NAVs usually compete for larger sites where they can offer prices below the average cost, and incumbents are a back-stop for smaller developments. In effect, companies ought to be indifferent to the route by which sites are connected and behave accordingly.

As the CEPA report says, a margin would open up part of the market to new entrants, because they would only need to match incumbents' costs in order to make a profit. But if part of incumbents' profit is tied to the amount of this work we undertake, then you would expect incumbents to be able to compete – ie, by offering lower unit prices on larger sites that are cheaper to connect. This might make for more vigorous competition, but with a risk of more disputes about whether incumbents are giving equal treatment to NAVs and SLPs.

Our suggestion is that option 5 is the best for contestable developer services. We suggest that you take all contestable developer service costs (site-specific) out of the network plus price controls (ie, move from a single till to separate tills3) and rely on Ofwat's charging rules for regulating charges to developers. This will promote competition in developer services, allow you to simplify the price controls and to remove the DSRA reconciliation mechanism, which is only required because of the "single till".

Residential retail

We consider there is no clear rationale for residential retail being a non-indexed control. We note that in the Retail Exit Code protections for small non-households (those most like residential customers), Ofwat decided to apply an indexing control, which makes the continuation of the current non-indexed approach for residential retail inconsistent with the market. For non-household retailers, Ofwat acknowledged that inflationary pressures applied and that the simplest way to deal with these was by indexing costs in line with CPIH.

We welcome simplification of the revenue control and think that this step would simplify matters to some extent. However, we don't think that the requirement to forecast and adjust for the number of customers is particularly onerous. A much greater level of simplification could be enabled if the retail control was placed on the same footing as wholesale; it could then be combined within the Revenue Forecasting Incentive and we could assess variances in revenue for each service as a whole. It would not be necessary for the retail control to be indexed in order to do this.

For retail variances to be considered within the RFI, it would only be necessary to allocate retail revenues between water and wastewater so that they could be aggregated with other income from the service. If variances were considered in this way, there would be two side effects:

- It would convert the retail reconciliation to an in-period effect.
- Variances in retail revenue recovery would be adjusted for inflation (even if the base level of revenue in the control was not indexed).

Even if Ofwat chooses not to index residential retail, we think that the second effect is very small and should be accepted for the sake of simplicity.

Q8.3: Do you agree with, or have any comments on, our proposals spanning multiple parts of the value chain, ie for major projects and future reconciliations?

We think there is a lot of merit in allowing major projects to be brought forward and funded at any time, not just at price reviews. This would enable Ofwat to determine such schemes outside the price review, allowing time for a more detailed assessment of large investments and avoiding being constrained by the price review timetable. Ofwat could then check cost efficiency and customer protection at later review points, without having to revisit the approval of the project. Such an approach could speed up the delivery of long-term benefits for customers and the environment from investments that take longer than five years to deliver efficiently.

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[3] There are a number of other sources of income that are appointed but are not added to the revenue control for the purpose of the RFI; the most significant of these is bulk supplies. Ofwat deducts a forecast of third party income from the revenue requirement that has to be funded by other customers. The company then takes the risk relating to variances in this income stream between price controls.

If Ofwat did not add developer services contributions to the revenue control, they would still be taken into account as a contribution to appointed cost it is just that (i) they would not be counted in two places, and (ii) customers would not bear the risk of variances from forecast between reviews through the RFI.

We support you exploring whether the Infrastructure Provider could be awarded a project licence under the Specified Infrastructure Projects Regulations (SIPR) model and whether this would provide more benefits for customers than Direct Procurement for Customers (DPC).

Chapter 9 – Outcomes

Q9.1: What kinds of performance commitments should we include in the price review? What outcomes require financial incentives for all companies for the foreseeable future?

The outcomes regime has been a success. It has aligned the interests of companies with those of customers by incentivising improvements in service. It also encourages companies to reveal the level of improvement that is possible. The previous penalty-only regime delivered static service levels as companies only had incentives to hit targets, and to keep those targets the same. A symmetrical system of rewards and penalties has been critical in delivering service improvements.

Several companies have argued that there are too many Performance Commitments (PCs) and that the answer would be to have fewer, broader measures. We are not sure this is a realistic proposition. In order to construct such broad measures, we think we would still need to measure the same indicators so that they could be aggregated into a broad one – this would not simplify matters. For example, if we relied on a broad measure such as the amount of water a company abstracts from the environment we would still want to know whether that was the right amount – how much was lost to leakage, how much delivered and whether customers were being encouraged to use it efficiently. Broader outcomes will not stop us from measuring these things. We can either attach PCs to the indicators which are (relatively) easy to measure or to an overall outcome which may be more difficult to calibrate.

We don’t think that within the industry there are 675 PCs that are genuinely different. There are differences in measurement and incentive rates but this was to be expected when companies came up with their own proposals. Aside from a few bespoke PCs, the bulk of measures are addressing the same key requirements; it is quite easy to group them together. We think that much of the apparent complexity is a matter of presentation rather than substance.

Across several price reviews and all companies, research has tended to reveal the same top customer priorities: water that is good to drink (quality), a reliable supply and wastewater being taken away safely. In other business plans the description will have been slightly different, but the themes are the same.

Water quality – the DWI has only recently brought in CRI as its key measure and this is likely to remain for the foreseeable future. Severn Trent also has water quality complaints, which is a more customer-driven measure.

Reliability of supply is a more complex area. There are measures that describe the customer experience (interruptions, low pressure) and also indicators regarding whether the company has sufficient security of supply (risk of restrictions in a drought). Resilience measures are a related area, dealing with the risk of customer supplies being interrupted.

Wastewater taken safely away – the key customer-facing measures relate to sewer flooding. As the most serious service failure a customer can experience, sewer flooding PCs should remain in some form – whether separate internal and external measures as at present or some form of combined measures which takes account of consequence. Customers are also concerned about pollution events even if they do not experience these directly.

Research helps inform the types of performance commitments that have enduring importance to customers, and which should be maintained into the foreseeable future. But customer preference should not be the only thing that determines whether a financial PC should exist. There are risks to service in the future which will not be obvious to customers because they will not experience any effect from them right now. It is important that incentives are also attached to longer term measures so that they are not devalued.

Asset health is one example of a long-term outcome which we think should be incentivised. This is not something that will emerge from customer research about their priorities, but when questioned in focus groups customers will say that companies should ensure that their assets can continue to deliver. It is important that companies maintain their assets so that they can continue to deliver for customers into the future; this may not be apparent from service delivery measures such as the number of flooding incidents that have occurred. But measuring asset health directly is not simple – there are things that we can measure and observe, but they are lead indicators rather than being outcomes in themselves.

As discussed above, we think it is better to place a PC against the indicator rather than attempting to construct a basket of measures which comprise asset health for a service. The latter approach still involves measuring the same things but placing some kind of weighting on them to form an overall index – this would be more complex than the existing approach, even if it reduced the headline number of PCs.

Bespoke outcome delivery incentives

We understand and support Ofwat's desire to simplify the price control framework where possible. As we say in our executive summary, we consider that bespoke ODIs, even if fewer in number, should remain a vital part of the outcomes framework because they allow companies to innovate with different service improvements. National research will only take us so far because the demographics of each company are different; what may be deemed essential by one group of customers will be perceived as a luxury by others.

Bespoke PCs encourage innovation in areas such as community engagement and nature-based solutions. A number of companies had bespoke PCs in these areas, eg encouraging water efficiency and discouraging sewer misuse, and catchment management through engagement with stakeholders. These often do not lend themselves to common PCs and more standardisation, and reducing the scope for bespoke PCs could discourage such innovations.

If companies are discouraged from having bespoke PCs, then we may see a "race to the bottom" where companies become less creative. One of the ways in which the outcomes regime has been successful is that it has encouraged companies to take ownership and to reveal what they can do – the old target and penalty approach did not push the industry forward. Where demonstrably successful, bespoke PCs can be rolled out to all companies at future reviews and will help to ensure that common PCs do not become static and unresponsive to changing customer needs. What matters is having the right protections for customers in aggregate; we think that if Ofwat puts these in place then it will not need to be so prescriptive around the detail of company plans.

Longer-term measures

Individual performance measures can be quite volatile, and there may be variations that are not down to company action. However, over time there will be trends and if Ofwat commits to keep the same indicators this helps address the need for a long-term view.

We do not support rewards being contingent on the maintenance of a particular level of performance in future periods:

- Firstly, this undermines the aim of in-period ODIs. Having rewards or penalties closer to the performance which gives rise to them sharpens the incentives. Since the ownership and management of companies changes over time, it also means that the team responsible for a given level of performance are more likely to deal with the consequences.
- Secondly, if performance is not maintained then a company will simply suffer a penalty in future periods. This will negate the effect of any reward.
- Thirdly, we have seen that the incentive regime works far better if it is symmetrical, with rewards as well as penalties. If rewards were contingent on the continuation of performance, surely penalties should also be linked in the same way – in which case customers would not receive the immediate compensation for under-delivery.

Our preference would generally be for ODIs to be applied through revenue rather than through the RCV. Revenue rewards or penalties sharpen the incentives for companies and are more consistent with the intended effect of in-period incentives.

Shareholders do consider their total return based on RCV growth as well as dividends or profits, so adjustments to the RCV could be value-neutral compared with equivalent revenue adjustments. RCV adjustments will also reduce the immediate impact on customer bills because they spread the effect over a longer period, and the effect on financeability (in the case of penalties). But we think that companies will generally need to spend in order to deliver improved performance. This means that the majority of ODIs should be included in revenue, because companies should not be deterred from delivering improvements because of constraints on cashflow or concerns about gearing.

Q9.2: How do you think we should monitor outputs that are not clearly linked to the outcomes incentivised in the price control? Would it help to distinguish between PCs that monitor outcomes and PCDs that monitor outputs? What other options could we consider?

We support the concept of Price Control Deliverables (PCDs). At PR19 we proposed a number of “real options” which were essentially designed to deal with uncertainty – for example, we have a metering ODI which deals with variations in the number installed. The ODI payments we get through this vehicle are treated as revenue and considered part of our Return on Regulatory Equity when in reality they are just recovering cost.

Another point which distinguishes PCDs from ODIs is that PCDs are really dealing with an output rather than an outcome. The advantage of separating them is that it avoids confusion about what they represent, and unintended interactions with mechanisms that are designed to deal with ODIs. For example, since PCDs recover cost, they shouldn’t be considered part of a company’s Return on Regulated Equity. In addition, PCDs should not contribute to the overall cap on incentives because this could have the perverse consequence that if a company delivers a large output it will not have scope to earn a reward for delivering great service at the same time.

It may also be helpful to consider how we report against PCDs. The term “deliverable” may be a little loaded – a company could have a PCD that is designed to deal with uncertainty that has not arisen. This should not be reported as a “deliverable” that is off-target. They could be called something like output funding mechanisms (OFMs), which would clearly distinguish them from PCs[4].

PCDs can be flexible enough to deal with different types of output. Some – like our current metering ODI – could be linked to a unit of output and allow for in-period variations in volume. Others could be wholly end-of-period, linked to the delivery of particular outputs or – like our Green Recovery ODIs – allow for an element of funding within the control period with a true-up at the end. They do not necessarily need to be tied to a particular output – for example, they could also be framed so that they describe the outcome of a scheme (e.g. a volume of water). The company might have scope to develop a more efficient alternative which delivers the same outcome as the original scheme in its business plan. PCDs could also be set up as multi-AMP funding vehicles where large projects do not end neatly in line with the five-year cycle. This would fit well with the overall aim of taking a longer-term approach.

Q9.3: Do you consider there are aspects of company performance where it would be better not to set expectations as part of the price control? What approaches should we consider in these cases, so that companies act in the interests of customers?

Price controls are mostly concerned with considering the revenue that companies need in order to deliver the outcomes that are required of them. Where PCs have a financial reward or penalty it is clear that these need to be considered within the control, because the company needs to understand the level of risk that it is taking on before it agrees to a determination.

Reputational outcomes, while still important, can be considered outside of the price review. There are many aspects of company performance that can be measured and compared without these needing to form part of the price-setting process. Companies are still motivated to improve in these areas and do measure their performance relative to their peers; the incentive to improve will remain whether these are part of the package or not.

Q9.4: What should be our aim in setting the levels of performance commitments? Do you agree with the proposal that performance commitment levels should be set, as a starting point, at what can be achieved by an efficient company with base costs and that deviations from this are proposed in company business plans? If not what alternative proposals should we consider?

In principle, we think it could be a good idea for Ofwat to set out its view as to the level of performance that can be delivered by an efficient company. In practice, this process could be quite complicated. Ofwat needs to avoid the construction of a “perfect company” when establishing its baseline view – i.e. a company that has Upper Quartile (UQ) costs and UQ performance on all measures. In our view this happened to some extent at PR19, because UQ costs from econometric models were combined with an UQ level of ambition from company plans.

Any baseline should be grounded upon evidence of what at least one real company in the industry is actually delivering. But the construction of realistic baseline PCs will be a little more complex than simply picking one company as the benchmark. It is likely that efficient companies may have UQ performance on some measures but not others. The service level an efficient company can achieve for a given cost varies between companies due to a number of factors, such as weather differences,

[4] Note that for PCDs, you will need to define three terms as you have done for PCs / PC levels / ODIs.

raw water quality and population density. To present a realistic view, Ofwat would need to place a value on the measures where the company was not performing – that is, it would need to compensate by either:

- Allowing for the additional cost of bringing all measures up to the UQ within the base cost;
- Set some targets that are below the level that are being achieved (or which could be forecast to be achieved) by the benchmark company in recognition that there are other aspects of performance where it needs to catch up.

Both of these approaches require some kind of assessment as to the relative value of different performance commitments. The first requires some modelling of the cost to deliver PCs, which Ofwat is considering as part of its cost assessment workstream. Balancing using the latter approach could be done using either the cost of delivery or perhaps the value that customers place on the improvement. We would be happy to work with Ofwat as it develops its approach to target setting.

Timing is key. It would be very helpful to have an early indication of what the package of common PCs is, so that we can focus our research on the gaps and avoid overlaps and so that we can get our business to deliver on those common PCs for customers. If any new PCs are required, we would also need definitions to be laid down so that we can begin shadow reporting. We don't think that Ofwat should issue prescriptive guidance on bespoke PCs; if Ofwat is determining the bulk of PCs already then it should allow companies space to innovate and put forward measures that have customer support.

Given that the targets need to be available for companies to prepare their business plans, Ofwat will have to base their assumptions on data drawn from APR 22. We consider we will need to have this in October 2022 so we can incorporate them into our plan. The national customer research also needs to be available at this point because this will provide the values that allow companies to assess the risk that they are taking on, and any claim for costs to deliver improvements in performance. When companies were undertaking research for ODIs at PR19, establishing targets and values went hand in hand; Ofwat should recognise that these elements are all connected.

Q9.5: What approach should we take to setting ODIs? How should we take account of marginal costs and marginal benefits in setting ODI rates? What are the risks and benefits of the approaches that we set out, or any others that you propose?

We welcome Ofwat's efforts to simplify price setting where it can and we understand the difficulty that was presented by large variations in the industry's view of marginal cost. There was also a wide variation in company assessment of customer valuations, but if these are set using standardised research it should reduce this problem. Indeed, if Ofwat is setting incentive rates ahead of plan submissions, we think it is probably necessary to adopt this kind of approach to make this process manageable.

On the other hand, the framework document discusses whether performance levels can be taken into account within cost modelling. As we have discussed in response to Q9.4, it may be necessary to have a view about the incremental cost of delivering UQ performance when constructing a plausible view of what an efficient company can deliver within base costs. So while it may be helpful to break the mechanistic link between marginal cost and incentive rates, Ofwat should not lose sight of the fact that improving performance will have a cost. Companies will still need to have a view of this in order to evaluate the implications of the Ofwat targets and any cost claims they may wish to make in order to deliver them.

Chapter 10 – Cost assessment

We welcome Ofwat's commitment to building on and refining its cost assessment process used at PR19. Econometric models have been shown to be effective for the assessment of repeating and comparable costs where the logic can be demonstrated. This needs to be supplemented by appropriate review of business cases where use of models is not suitable. As at PR19, we look forward to constructively playing our part in this process by actively supporting the cost assessment working group.

We make the following summary points. These are then expanded upon when responding to the specific questions below:

Modelling / efficiency challenge improvements

- The cost – cost driver relationships inherent within selected models must be evidence-based, robust and remain relevant in the future.
- Econometric model performance should be objectively considered when setting catch-up efficiency challenges.
- The context of cost assessment within the wider price review framework is critical – observed relationships between cost and performance need to be acknowledged rather than cost and performance benchmarks being set separately.
- We welcome the consideration of releasing econometric models in advance of company business plans. However, the timing and definitiveness of published models is important if the anticipated benefits are to be realised.
- Fluctuations in industry wide investment because of Covid-19 need to be accounted for so as not to distort efficiency calculations.

Appropriately accounting for long-term cost requirements and incentivising innovative / sustainable delivery methods in the cost assessment approach

- Long-term cost requirements not suitable for assessment using backwards-looking econometrics should be objectively identified and an alternative approach used (e.g. a targeted review of business cases supplemented by separate activity-based models where they can be generated).
- Modelling costs on a present value rather than expenditure basis could better identify the efficient delivery of long-term costs. However, this would be a complex and innovative solution, therefore it could realistically be an approach for longer-term consideration.
- Incentives have a key role to play where cost modelling options to reflect long-term cost requirements are overly complex or impractical. They could be used to remove potential efficiency incentive barriers or cost recovery risks associated with longer term solutions.
- Cost assessment incentives should prioritise delivering whole-life benefit to customers. We understand the desire to see costs shared equitably between stakeholders where there are also wider benefits. However, where whole-life benefit to customers can be demonstrated, we think it should not then be disincentivised by additionally needing to disproportionately guarantee the sharing of costs with 3rd parties.
- A review of resilience definitions would help to improve clarity and comparability. This should also better link with managing asset health and maintenance in the face of changing external stresses.

- When considering long-term resilience and asset health requirements, more effective linkages to external long-term planning frameworks would be desirable. This would allow focus on assessing the efficiency of externally-validated proposals rather than making judgements about the need for investment.

Q10.1: What should be the priorities for improving our approach to cost modelling and assessment?

When considering model development and selection, it is very important to remain true to engineering, geographical and economic expectations. The cost : cost driver relationships inherent within models must be evidence-based, robust and remain relevant in the future. We consider that it is essential to objectively define when econometric models are, and more importantly are not, well placed for identifying future expenditure requirements.

During PR19 we developed a high-level PR19 model selection framework[5]. This set out a methodology for considering the extent to which models conform to prior engineering and economic expectations of what drives the costs that the sector incurs. This framework approach remains relevant today, but our PR19 document focused on water network plus costs. Therefore, we plan to expand it so that is accounts for all costs. We suggest Ofwat should seek to retain higher levels of model performance using model scopes only where the cost : cost driver relationship is strong. Adding further costs where the future cost : cost driver relationship is not as clear will reduce the level of confidence in the overall cost assessment approach.

The consideration of model scope is closely linked to the regulatory definition of enhancement expenditure. Future cost pressures are placing this under increasing challenge with the categorisation of expenditure becoming increasingly complex and subjective. Therefore, we consider it would be an appropriate opportunity to review the definitions so that the premise remains clear and links to the future modelling requirements and the data is as consistent as possible. This is likely to be helpful for a range costs that have previously proved challenging for cost assessment including: growth costs, resilience costs and maintenance costs in the face of a changing climate.

We welcome Ofwat's ongoing attempts to improve the quality and breadth of potential cost driver data. Comparative data of an appropriate robustness is essential if credible models are to be developed. In general, the length of the modelling panel should be expanded as much as possible. This will increase the number of model observations and help the statistical performance of models. However, it is also important to make sure that the dataset takes account of the fluctuation in costs through the regulatory cycle or in response to macro-economic events. This could be delivered through model panel lengths being a multiple of the five-year price control or through the use of dummy variables. The likely impact of Covid-19 on industry expenditure should also be given close consideration because material changes are expected which are unlikely to reflect true efficiency performance.

Econometric model performance should be objectively considered when setting catch-up efficiency challenges. Models, adjustments and efficiency assumptions all need to align to build confidence in a robust and effective cost assessment approach. It is understandable that significant effort should be placed on the development of effective econometric models. However, the way in which the selected models inform efficiency challenges is also a fundamental component of a robust cost assessment

[5] https://www.severntrent.com/about-us/future-policy/water-cost-modelling-framework-/

approach. There should be a clear link between econometric model performance and the setting of the catch-up efficiency challenge. The extent to which the catch-up efficiency challenge is set relative to the frontier performance should be a function of the limitations and statistical noise in the models rather than be used to set the inherent challenge of the cost benchmark.

To maintain appropriate confidence in the cost assessment methodology, we think Ofwat should seek to develop and use a method that can calculate an appropriate catch-up challenge rather than relying on regulatory judgement. This could include considerations of model scope, the coherence of the cost: cost driver relationships relative to engineering, geographical and economic expectations and the statistical performance of the models. As a minimum, the basis of the catch-up challenge should be assessed relative to other regulatory cost benchmarks (e.g. PR14, PR19 and Ofgem's RIIO-GD2 and RIIO-ED2) to provide a level of consistency.

Q10.2: In what areas (both historical water sector and external) can we improve the range of benchmarks we use in cost assessment?

We understand the desire to benchmark the efficiency of water companies, either in comparison to other similar sectors, or in areas outside of England and Wales. This is something we did to an extent in Appendix 8 of our PR19 business plan as we explain below.

However, widening the range of benchmarks is challenging because accurate efficiency benchmarking requires identified activity to be comparable and data to be reported to similar definitions. We also think that the impact that granular efficiency benchmarking of specific costs might have on the ownership of company strategies should also be actively considered.

We have previously explored using the European Benchmarking Co-operation initiative to provide cost and performance insight. The programme collects information from participating water and sewerage providers from across Europe. It then provides anonymous benchmarking information back to those involved. We are also aware that some but not all English / Welsh companies have previously participated. However, our experience was that the resulting information was highly likely to be strongly influenced by data/ interpretation issues and very sensitive to regional / organisational contexts. Consequently, we are no longer an active participant and do not consider that such information would be appropriate to infer comparative efficiency or performance data in a price setting context.

Candidates for cross-sectoral benchmarking could include: support function costs; labour costs; or indirect capital programme costs. These will not be specific to the water sector but should have a level of comparability in similar organisations. Ofgem has previously isolated business support costs. This was used to expand the data panel for modelling by allowing for the inclusion of all energy companies. CAA have also used external benchmarking for labour costs in their regulation. However, consideration should be given to the validity and accuracy of benchmarking at this much more granular level. We do not currently report at these differing levels of cost breakdown and it is likely that other sectors and companies will account for them in slightly different ways.

There are challenges of ensuring consistency of reporting between water companies at this more granular level, and a need to preserve management responsibility for company strategy. Therefore, it might be more appropriate to instead place the onus onto companies to demonstrate how they have sought external information to expose opportunities for efficiency and challenge when developing their business cases. This would provide visibility that companies are using appropriate tools in decision making without becoming unnecessarily burdensome or restrictive. As an example, we provided independent benchmarking information on identified direct costs and indirect capital programme functions (as conducted by Arcadis and Turner and Townshend) in Appendix 8 of our PR19 business case.

Q10.3: How can we take account of longer term ambitions such as delivering net zero and increasing public value in our approach to assessing costs?; and,

Q10.4: Do we need to amend our cost assessment approach to take account of nature based solutions?

The current cost assessment approach relies on backwards-looking econometrics for assessing routine expenditure. This assumes that historic costs and their relationship with identified cost drivers are reflective of future base expenditure requirements. This assumption will come under increasing stress as new pressures facing the sector crystalise, or innovative solutions that generate wider benefit are identified. Consequently, we think it there will be an increasing role for a range of adjustments and incentives that then allow econometric models to focus on costs that they are suited to forecast.

We support the need to focus on wider benefits delivered rather than solely on the lowest-cost deliverables. In practice there are normally procedural and logistical barriers to delivering collaborative interventions at scale over and above any economic barriers. Therefore, where whole-life customer benefit can be demonstrated, cost assessment incentives need to be devised and scaled to overcome these wider barriers. Cost recovery barriers to long-term sustainable solutions could also potentially be alleviated by reconsidering how costs are added to and recovered from the RCV. Whilst we understand the desire for an equitable distribution of costs between customers and wider stakeholders, we do not think this should override the primary incentives for funding of interventions that will generate whole-life benefit for our customers.

Marginal costs that can be demonstrated as delivering long-term benefit to customers or wider society are likely to be poorly reflected in econometric models. These costs – including for carbon-neutral solutions and the use of nature-based solutions – are not likely to have been previously incurred, or will look inefficient when only reviewed over a shorter period of time. Developing a framework that objectively considers where costs are, and are not, suitable for existing econometric modelling would help to identify were alternative approaches are needed. It would also increase the confidence of accurately assessing the residual costs that remain in econometric models.

The most certain way to assess costs that cannot be adequately reflected in current models is through a targeted review of business cases supplemented by separate activity-based models where they can be generated.

Incentives (in line with or similar to existing ODIs) could have a powerful role to play where alternative cost modelling options are overly complex or impractical. They could be used to remove any potential efficiency incentive barriers or cost recovery risks associated to longer-term solutions. Activity which would be whole-life beneficial but short-term inefficient, could trigger an outturn incentive to recover cost and compensate for the perceived inefficiency. Calibrating these incentives would be difficult. However, they could use valuations for external benefit where they are available, or bespoke comparison of whole-life costs with counterfactual solutions.

A more radical alternative at better reflecting long-term costs in cost assessment could be to model costs on a present value rather than an expenditure basis. This could also include cost externalities (such as valuations for carbon and biodiversity/ecosystems services). It would provide a much clearer view of the efficiency of company decisions over the whole life of interventions rather than just a snapshot in time. However, such approaches would be highly data intensive and rely on many assumptions to ensure comparability. Therefore, this would realistically be for longer-term consideration or potentially more applicable for a targeted set of costs.

Q10.5: Where can we enhance our evidence base on the relationship between costs and service?

The context of cost assessment within the wider price setting framework is critical – observed relationships between cost and performance need to be acknowledged rather than cost and performance benchmarks being set separately.

We welcome the consideration being placed on how future service improvements should be funded. The consultation document rightly identifies that the interaction between cost and performance levels is a complex one that is often a function of competing trends. For example, increasing performance can concurrently lead to a reducing failure demand (driving costs down) but also increasing marginal intervention costs and whole-life costs (driving costs up). Moving from a theoretical discussion to quantified relationships would likely require detailed analysis and investigation into a targeted performance attribute. This would need to consider costs in a broader sense, for example direct opex and capex over time as well as associated indirect costs and externalities.

Q10.6: What mechanisms should we consider for the efficient funding of performance levels, set in a long-term context, that vary from those an efficient company would deliver through its base allowance?

A fundamental objective of the regulatory framework is to incentivise companies to be efficient. To do this, both expenditure and performance levels need to be considered when setting efficiency challenges. If the interactions between cost and performance are not acknowledged, there is a risk that the framework will could effectively incentivise lowest cost and highest performance to an extent that regulatory packages become unachievable.

Now is currently a good opportunity to re-consider and clarify the regulatory definition of base and enhancement expenditure. These definitions are integral to how base cost assessment approaches are developed and the way in which changing performance should be considered. Assuming current definitions, changing performance levels can relate to:

- catching up to expected benchmark levels of performance for which funding has previously been provided (which could be considered as base); or
- a step change in performance that has not previously been required or funded for (treated as enhancement).

At PR14 and PR19, companies were incentivised to catch-up to expenditure benchmarks based on the distribution of company costs to model outputs. However, econometric models have not included performance cost drivers. This is because performance is rightly considered to be within management control and could introduce endogeneity into models. In consequence, the base models inherently assume that performance is equal across all companies. Annual performance data shows that this is not true and that there is a complex causal relationship between cost and performance. This means that econometric model error terms will account for cost efficiency, performance variation and model specification noise. Without being addressed either within or outside of models, we consider that this is a fundamental weakness of the current cost assessment approach.

There are two fundamental aspects relating to the treatment of catch-up performance in cost assessment that should be considered in more detail:

The first is the extent to which companies have been required to operate to comparative levels of performance in the past. The previous serviceability approach held companies to a reference level of service derived from their own historical performance rather than an industry comparison. This means that there are likely to be different levels of efficiently incurred expenditure within the modelling dataset. It will also mean that catching up to comparative levels of performance could be analogous to enhancement where companies have not been funded to deliver that level of performance previously.

The second is the way in which the interaction between cost and performance should be accounted for when setting future cost baselines. There needs to be a way in which the efficiency challenge identified from econometric models takes account of performance benchmarks where they are not consistent. This could be managed as follows:

- The use of post-modelling adjustments where the variance between performance benchmarks and the performance achieved by the cost benchmark company (or companies) is quantified, valued and then applied as a series of systematic adjustments to all company baselines.
- Inclusion of performance metrics in model specifications (with endogeneity issues addressed separately).

Econometric models should not be used to assess step changes in performance that have not previously been required or funded for. These performance enhancements will not be represented in the historical cost dataset. Here, separate enhancement cost assessment approaches (such as separate models or regulatory review of business cases) or outcome delivery type incentives become necessary. We consider that the choice between a cost assessment or incentive approach for this type of expenditure should in part reflect the level of certainty inherent within the targeted/required future performance level.

Q10.7 – Is there more that we need to do to reflect future pressure on operational resilience in our approach to cost assessment?

We support a review of the resilience definitions to improve clarity and comparability. Understanding and managing the resilience of core services is complex and can include quite disparate activities. This makes it an important but challenging component of any cost assessment approach. Therefore, it could benefit from an increase in the granularity of assessment. In its current form, the resilience cost driver can relate to the management of high-impact low-likelihood events, responding to external hazards or alternative approaches to managing the risk of delivering core duties.

We also think that there should be a clearer linkage of cost assessment to the challenges of asset health and maintenance in the face of changing external stresses. The changing environment in which our assets operate is likely to mean that past cost: cost driver relationships are not likely to reflect future investment requirements. This means this expenditure will increasingly be categorised as resilience enhancement expenditure rather than being allowed for through base expenditure allowances that are derived from backwards-looking econometric models.

Q10.8: Are the most significant challenges to the operational resilience of the sector adequately captured within current strategic planning frameworks?

When considering expenditure requirements to maintain service in the long term it is important that there is a strong and effective linkage between the cost assessment approach and the external long-term planning frameworks that the sector uses. Frameworks such as WRMP and DWMP are:

- underpinned by detailed analysis,
- focused on identifying the need for future investment and the most appropriate way to get to the targeted destination; and
- are subject to external review and sign off.

Better integration would allow for an approach similar to that used for WINEP at PR19. This would allow Ofwat to focus on assessing the efficiency of proposals rather than having to assess the need for investment.

However, we would also stress that resilience should not be considered as a function of external planning frameworks alone. Long-term asset health is a necessary enabler and prerequisite. Future pressures that are not captured by base econometric models will therefore need to be funded through this process. This could be considered through a clearer linkage between the assessment of resilience requirements and the asset management maturity assessment (AMMA) framework.

Q10.9: How can we strengthen incentives for long-term operational resilience and improve the assessment of resilience enhancement expenditure while continuing to protect customers' interests?

We support Ofwat's long-term commitment to the outcomes framework. This will strengthen incentives for long-term operational resilience because companies will expect a core set of PCs, such as leakage, supply interruptions and internal sewer flooding to be incentivised over the long-term and will invest accordingly.

We also support a clearer linkage between the assessment of resilience requirements and the asset management maturity assessment (AMMA) framework.

As we say in our response to Q9.1, we do not support rewards being contingent on the maintenance of a particular level of performance in future periods because:

- Firstly, this undermines the aim of in-period ODIs. Having rewards or penalties that are closer to the performance which gives rise to them, sharpens the incentives. Since the ownership and management of companies changes over time, it also means that the team responsible for a given level of performance are more likely to deal with the consequences.
- Secondly, if performance is not maintained then a company will simply suffer a penalty in future periods. This will negate the effect of any reward.
- Thirdly, we have seen that the incentive regime works far better if it is symmetrical, with rewards as well as penalties. If rewards were contingent on the continuation of performance, surely penalties should also be linked in the same way – in which case customers would not receive the immediate compensation for under-delivery.

Chapter 11 – Risk and return

Q11.1: Are there areas of our risk allocation framework where mechanisms could be added, simplified or removed in a way which would benefit customers?

We have identified some areas below where we consider changes to the risk allocation framework could benefit customers. We will highlight further potentially beneficial changes that we identify as the PR24 process progresses.

Business rates

We consider it appropriate for there to be full pass-through of business rates for the 2025-30 period. This would fit with broader efforts to avoid windfall gains or losses arising as a result of taxation changes, and would align with the approach taken to business rates in some other regulated sectors, including energy. We note that the CMA considered that management has limited scope to reduce business rate charges, and took the view that a 90/10 (customer/company) split was appropriate for AMP7 (compared to the 75/25 split provided for in the PR19 final determinations).

In practice, we consider that the scope for companies to reduce business rate charges is likely to reduce further over time, as the methodology to be applied by the Valuation Office becomes more established through the AMP7 period. At the same time, there may be other factors (associated with the calibration methods that the Valuation Office applies) that could give rise to unexpected differences between forecast and actual business rates costs, and associated windfall gains or losses. There can be significant uncertainty over the extent to which such changes might arise in a context where valuations occur every three years, such that two valuations can affect a price control period the outcomes of which were not known when allowances were forecast.

Given this, we consider a full pass-through of business rates to be the most appropriate approach to adopt for the 2025-30 period. Importantly, it would avoid potentially undesirable legitimacy concerns arising in circumstances where forecast and actual business rate levels differ. This could be achieved by setting fixed allowances but including an ex post adjustment mechanism.

Removal of references to a *K* factor in the wholesale controls

The *K* factor was required when the price control set a Weighted Average Charge Increase. With the development of revenue controls the *K* factor is no longer needed to define the control, but the wholesale revenue controls are still applied by converting the revenue allowance into a *K* factor. The mechanics of the wholesale controls could be simplified by specifying them directly as revenue controls and removing the references to *K*. It is notable that the retail and bioresources controls are already set without a *K* factor.

The Developer Services Revenue Adjustment (DSRA)

We are suggesting removing contestable developer services from the network plus revenue controls to strengthen the market in those services and that Ofwat relies on its charging rules instead to protect entrants. This would allow for the removal of the DSRA, and the significant complexity involved in applying it.

Q11.2: How should we improve our use of RoRE risk ranges to provide insights into the balance of risk and reward, and improve comparability across companies?

We support the continued use of Return on Regulatory Equity (RoRE) risk ranges as a means of helping to understand the magnitude of financial impacts under the price control arrangements associated with different risks. We consider RoRE analysis forms an important part of assessing the risk-reward balance that companies face.

We support efforts to improve the comparability of RoRE ranges across companies for PR24 by improving the consistency of the RoRE measurement approaches. This could involve the development of a standardised set of RoRE measurement approaches that all companies would be required to use to construct RoRE ranges that facilitate comparisons. Where a company did not consider the use of these standardised assumptions to adequately reflect the risks it faces, it could include quantification of the effect of adopting different measurement assumptions within its RoRE sensitivity analysis.

We support efforts to explore whether greater insight of RoRE can be achieved through the use of risk measurement tools. We note, in particular, that Monte Carlo analysis can provide an effective means of better understanding the distribution of RoRE risks and that it formed an important part of our assessment of ODI risks during PR19. Developing the use of this form of analysis could help provide for a more refined and robust understanding of RoRE ranges.

Q11.3: Should we index the allowed return on equity, and if so, how ought this to be implemented?

We do not currently have a firm view on the merits of indexing the return on equity but consider that careful attention would need to be given to assessing the potential impacts of such a change before its introduction could be justified. One important set of considerations concerns the additional complexity that such an approach may introduce, and the scope for that complexity to be associated with other unintended effects. For example, the mechanism would require the introduction of another relatively complicated reconciliation process – in a context where the number of reconciliation mechanisms was identified as a recurrent concern in feedback on PR19 related to complexity – and the operation of this could have material cashflow implications. We consider it is important that the potential adverse effects of such a change are carefully identified and assessed when net benefits are being evaluated.

Q11.4: To what extent should we place weight on a) balance sheet data; and b) index data when setting the allowed return on debt?

We consider index data to have a number of positive characteristics as a basis for setting the allowed return on debt. In particular, it can provide an objective and broadly-based source of information on debt costs over time that does not rely on company-specific assessments of debt costs. At the same time, we note the concern that it may be difficult to capture the key characteristics of water bond issuance in any one index, and that this may mean there is a risk that an index-based allowance is over-generous relative to actual debt costs.

For PR24, as was the case at both PR14 and PR19, we consider it will be appropriate to put some weight on both index data and data on actual debt costs. We note that the CMA placed more weight on using actual debt costs as the starting point for setting allowances in its March 2021 redeterminations. However, the range of issues and assumptions considered in the CMA's assessment highlighted many of the challenges and complexities that can be associated with developing a robust comparison of actual debt costs.

The redesigned data collection approach to be used in the annual performance report from 2021-22 should help improve the comparability of debt cost information going forward, but the development of robust comparisons is still likely to face significant challenges. In line with this, we consider it appropriate that the question of the relative weight to be given to balance sheet data and index data be kept under review, and informed by an assessment of the effectiveness of efforts to improve the robustness of balance sheet data comparisons.

Q11.5: Should we allow adjustments to the sector allowed return based on company size – and how should this be assessed?

We have no comments in response to this question.

Q11.6: Should we make different assumptions for the PR24 notional structure compared to PR19, and how should such a change be implemented?

We profoundly disagree with the proposal to change the notional company gearing to 55%. We understand that you are concerned about companies' financeability and their credit ratings, but we think this is a counterproductive solution, which will lead to worse outcomes for customers. For example, if companies have to de-gear during AMP8 this will squeeze the investment that is needed to deliver net zero, tackle storm overflows and introduce more nature-based solutions, which goes against the wishes of our stakeholders and customers. It also seems perverse for the sector not to take advantage of very low interest rates and an increasing tax shield on behalf of our customers (which ultimately leads to lower bills). We think the proposal is likely to disproportionately affect the listed company model, which works so well for customers, because we cannot rearrange debt between HoldCo and MidCo. However, we also recognise your concerns and would like to work with you on alternative solutions for financeability without the damaging side effects of changing the notional company gearing assumption to 55%.

Q11.7: Do you have any suggestions for mechanisms which could incentivise financial resilience within the price control process?

We will seek to engage constructively with any options that Ofwat seeks to develop in this area. We have actively contributed to the debate on financial resilience over time, including through the Changing Course through Sustainable Financing[6] report that we developed with National Grid nine years ago ahead of PR14. That report highlighted, among other things, how the introduction of rewards and penalties dependent on the relationship between a company's actual gearing and the notional level could be used to encourage improved financial resilience.

We do not have any firm proposals in relation to this issue at present and matters have moved on since our *Changing Course* paper nine years ago. However, one option that merits consideration is the introduction of a common ODI for financial resilience. Performance could potentially be determined by the outcome of a form of financial resilience 'audit' against a pre-defined set of measures and criteria. Another option could be more financial reporting for highly-geared companies, which if it revealed issues, could justify awarding a premium to companies with high credit ratings and/or low gearing.

[6] https://www.severntrent.com/content/dam/stw/ST_Corporate/About_us/Docs/Changing_course_sustainable_financing.pdf

Q11.8: To what extent should we further increase the share of the notional company RCV which is indexed to CPIH in our assumptions for the period 2025-30, and how should this be implemented?

We support a full transition to CPIH indexation at PR24, such that 100% of the notional company RCV is indexed to CPIH by the end of the 2025-30 period. We note that approximately 60% of the sector's RCV will be indexed to CPIH by the end of the 2024-25 financial year. We consider it appropriate for PR24 to complete the transition away from RPI, given its now long-recognised weaknesses. A full transition would also help simplify the indexation arrangements going forward.

Chapter 12 – Next steps for PR24

Q12.1: What are your views on the draft timetable for PR24?

We welcome the additional information you have provided about the draft timeline for PR24.

We support you providing initial views on base costs, PC levels, ODIs and financing costs ahead of business plan submission. To make this effective you need to provide these initial views when you have had time to collect the evidence and formulate them on the one hand, and in time for companies to change their business plans to reflect the information on the other hand.

We suggest you provide the initial views on base costs, PC levels, ODIs and financing costs in October 2022. In our view this is the latest date that will allow us to make meaningful changes to our business plan to reflect your initial views.

We also suggest that **Ofwat provides the results from its national customer engagement to companies in October 2022.** This will allow companies sufficient time to include the results of the engagement into their business plans and make meaningful changes to their plans if required.

Appendix – Examining the boundary of the targeted control for water resources

Q14.1: How can costs and incentives for the existing water resources control be targeted more effectively?

The best approach to costs and incentives for the water resources price control depends on what Ofwat wants to achieve. We note that in the main consultation document it says "After consulting stakeholders we have concluded that interest in bilateral markets is currently limited. In PR24 we intend to prioritise work likely to yield the best outcomes for customers." (page 76). If Ofwat wants to maintain the scope for bilateral markets in the future it might not want to combine the potentially competitive (water resources) and natural monopoly (raw water distribution and water treatment) parts of the value chain in the same price control.

If Ofwat is concerned about the effectiveness of cost models (Section 2.1) and companies not focussing sufficiently on reducing total costs where there are synergies across the price controls (section 2.2) Ofwat might want to consider moving back to one water price control for PR24 (covering water resources, raw water distribution, water treatment and treated water distribution). Ofwat could still use the time until PR29 to better define a price control that fits with its long-term ambitions for the sector.

Q14.2: Would amending the boundary to include raw water distribution or to extend it further to include water treatment improve the operation of the control? What are the issues involved?

As we said in our answer to Q14.1, we are not sure what the motivation is for expanding the water resources price control because it seems to be mixing potentially competitive (water resources) and natural monopoly (raw water distribution and water treatment) parts of the value chain. We can see a case for simplifying the water price control for PR24 by moving to one water price control as explained in our answer to Q14.1.

Our main concern with the proposal to change the water price controls is that there is no explanation of what the regulatory protection for the RCV in the new price control would be. We would like to understand more about the proposed approach through engagement over the coming months.