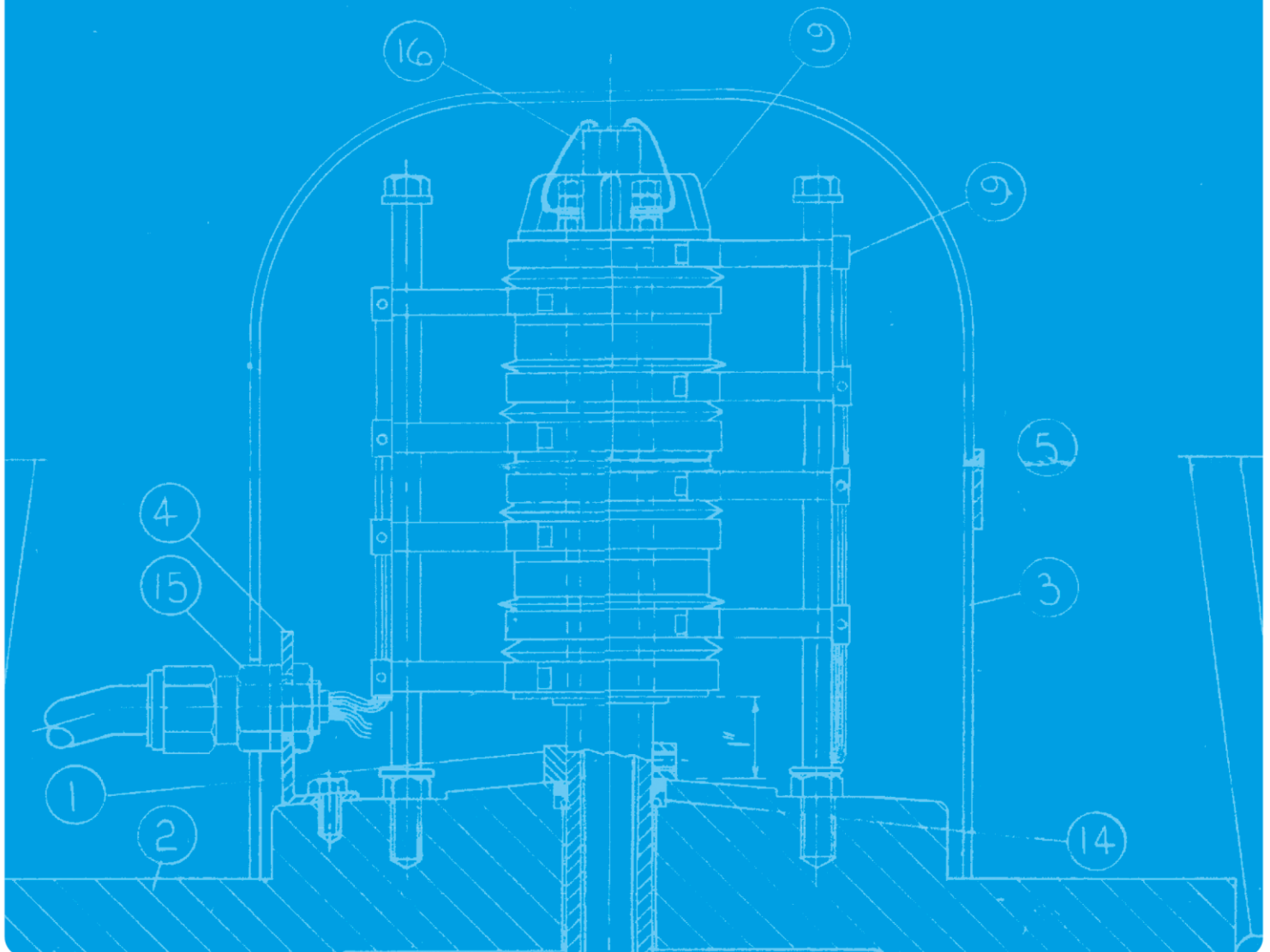


# Water 2020: Regulatory framework for wholesale markets and the 2019 price review

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# Water 2020: Regulatory framework for wholesale markets and the 2019 price review

## Summary of our response

The water sector is at an exciting time. There is now a far greater focus in the sector on customer outcomes, with PR14 delivering a reduction in bills and far stronger incentives for companies to become efficient and deliver better services for customers.

Since PR14 some very significant strides have been taken by Ofwat to further develop the regulatory framework that underpins the sector. Critically, companies have responded, including through the market place for ideas.

We recognise that the water sector needs to continually evolve if we are to continue to be effective in delivering what customers want in the future. Our vision is that by 2020 we are the most trusted water company; by delivering outstanding customer experience; the best value for money; and environmental leadership. This means that we need to:

- better understand the priorities of our customers and embed these at the heart of all we do; and
- drive operational excellence so that we can deliver higher service levels where our customers value them most, whilst keeping bills low.

Ofwat's overall proposed framework for wholesale markets and the 2019 price review will help us deliver our vision by creating a much stronger emphasis on companies competing to deliver the best service for their customers. This applies to direct competition between companies to deliver sludge and water resource services; and more widely through the use of comparative competition to identify and reward the best performing companies. The need to challenge ourselves is something we have embraced and we have set ourselves the goal of delivering at least upper quartile performance for both total expenditure and customer services by 2020. We therefore fully support Ofwat's proposals to drive a more competitive and customer-centric sector.

Overall we think the reforms proposed by Ofwat have the potential to deliver enormous benefits to customers through lower prices and higher service levels. The ideas around sludge competition are perhaps the most exciting given recent technological developments and we think will help promote a more innovative and sustainable sector.

Whilst we support all of Ofwat's principles there is one specific proposal, the proposed use of CPI indexation, which we do not agree with. We have also identified a small number of proposals where we think Ofwat can deliver better outcomes through less intervention, namely the information requirements for the sludge market and how schemes are tendered.

## CPI indexation

We do not believe the current proposals relating to CPI indexation will deliver the best outcome for customers. Bills and service levels will remain the same, and whilst bill volatility will be reduced, it will come at a cost of:

- reduced transparency;
- additional costs; and
- undermining investor confidence, most notable since we are asking them to fund long term investments whilst they are only offered 5 years of certainty about indexation.

To deliver the best result for customers, it will be important that bill volatility is reduced whilst investor confidence in the regulatory regime is maintained. This could be achieved by indexing bills and new additions to the RCV by CPI, and indexing historical (pre-2020) RCV by RPI. This would also have the added benefit of providing a clear timeframe for the termination of RPI indexation which the current proposals lack.

## **Delivering better outcomes for customers**

We are very supportive of sludge competition and, like Ofwat, think it will help unlock better capacity utilisation and drive the development and adoption of new technologies. To drive the best outcome for customers it's critical that there is genuine competition between companies and third parties. We think further thought is needed about the information requirements otherwise it could have the adverse effect of undermining competitive behaviour.

We also support Ofwat's desire to introduce competition in the procurement of services. This will help ensure that customers pay the lowest possible price for their water and waste services.

The current proposals can only apply to large stand-alone schemes, of which there are likely to be very few and while the £100m threshold might be appropriate for the largest companies a lower threshold might be appropriate for smaller companies. We also note that this mechanism is only likely to work effectively where it relates to investment that is readily separable from existing activities and does not involve intervention from multiple regulators. As such we believe Ofwat should also consider applying different forms of tendering to large integrated assets.

## **Next steps**

We are supportive of the overall framework proposed by Ofwat, but believe the proposal in relation to the use of CPI need to be reconsidered.

Our support of the package today is in the context that some of the proposals could potentially disadvantage Severn Trent. However in the round we consider that the package (excluding CPI) is appropriate. Looking forward it will be important to consider how the methodology that is ultimately applied adopts the right balance of risk and reward.

Our response to the consultation is attached in the accompanying template. For the proposals relating to CPI indexation and direct procurement we have also attached separate papers.

## Appendix – Ofwat questions

### Overview document

#### SQ1. Do you agree with our proposals for making a greater use of markets in relation to sludge and water resources?

We are very supportive of the proposals for sludge and (new) water resource markets. Like Ofwat, we strongly believe that competition, deployed in the right way, will increase the incentives for companies to realised efficiencies and ultimately deliver lower bills for our customers.

In our recent publication in our changing course series ‘Charting a Sustainable Course’ one of the key policy questions we raised was how do we deliver innovation and introduce market solutions for the benefit of customers? We asked this question because we recognise that how competition is utilised can have a significant impact on customers – through lower bills if done right, or through higher bills if delivered badly.

We think that Ofwat’s focus on introducing competition for sludge and new water resources is right. There are significant opportunities for sludge competition to deliver benefits to customers, particularly though better utilisation of capacity and applying new technologies. We also consider that the barriers to sludge competition are much lower because companies can more readily reconfigure their networks. However we would emphasise that delivering benefits to customers requires genuine rivalry between companies and third parties.

To promote competition we agree that the provision of some data is necessary – this will help reveal market opportunities and allow parties to make better decisions. However we are concerned that the volume of data required and approach to asset valuations could have the unintended effect of undermining competitive behaviour. This could occur by reducing the ability of companies to compete aggressively on price/service and raising the cost of operating in the market.

For water resources, we support the proposal that there should be competition for the provision of new capacity. Given the challenges with reconfiguring networks and high sunk costs, competition for existing capacity would not deliver benefits to customers and instead would simply increase bills. We are therefore very supportive of Ofwat’s focus on ensuring that the measurement of the Long Run Incremental Cost is done in a way that promotes efficient entry (i.e. where it displaces more expensive proposed supplies).

#### SQ2. Do you agree with our proposals in relation to the future form of regulation for the sector?

We are very supportive with the principles of the consultation and all but one proposal, CPI indexation. Leaving to one side CPI indexation, for all other proposals it’s apparent how they will deliver lower bills and/or higher service levels to customers.

The proposals around CPI indexation are however different. We don’t agree that this is the best way to improve transparency; the changes proposed will create additional costs and undermine investor confidence. We think that Ofwat can better reduce bill volatility and transition away from RPI by indexing revenues and new RCV by CPI and old RCV by RPI. This approach will also provide investors

with certainty about the transition away from RPI, whereas at present there is only 5 years of certainty.

We also support Ofwat's desire to promote more tendering. We think the proposal can be improved because at present the direct tendering proposal would only be applicable to a small number of discrete stand-alone schemes like reservoirs. We think applying different types of tendering to different types of assets would help deliver additional benefits to customers.

Finally we think there are opportunities for Ofwat to reduce the regulatory burden and in doing so, increase the level of competitive behaviour. This is particularly relevant for sludge where trading guidelines and large information requirements might encourage companies to adopt very risk-averse strategies instead of vigorously competing for market share

See individual responses to more detailed consultation questions below.

### [SQ3. Do you agree with our proposals in relation to customer engagement and outcomes?](#)

We are fully supportive of the challenge from Ofwat that companies need to improve how they engage with customers and how they then use the views expressed by customers in developing their business plans. Customers are at the heart of our new strategic framework. In order to deliver our strategic ambition, truly put our customers first and be trusted by them, we need an increased understanding of what is really important to them.

A notable feature of the W2020 consultation is that Ofwat is setting expectations rather than defining specific actions or initiatives (as per sludge competition). We support this approach as we don't think there is a definitive answer as to what good customer engagement looks like. Instead companies will need to try new methods and continually adapt their tools and processes to learn from their experiences. If Ofwat sets specific actions or initiatives then it would have the potential to deter companies from trying new things, and lead to the lowest common denominator.

We also support the expectation that companies need to broaden how they understand customer priorities. We have challenged ourselves in this area and will be utilising information from multiple sources of evidence, particularly from our daily interactions, to reduce reliance on stated preference (although we expect these sources to be additive to stated preference).

We also welcome the challenge that customers should be engaged as 'partners who drive decision-making on an on-going basis'. This means that we (and other companies) will need to improve on PR14 and clearly demonstrate and evidence the golden thread from customer engagement to investment decisions.

Finally we support the principle that the CCG should challenge the company about how it has sought to understand customer views, balance different views and subsequently represent those views in the plan. The CCG should not be a substitute voice for customers or stakeholders in its own right. Similarly the CCG is not a substitute for Board ownership of a business plan. We comment below on the specific role of the CCG.

#### SQ4. Do you agree with our proposal to extend protection of the RCV to 2020?

The RCV is one of the central features of the regulatory framework. It helps to underpin investor confidence by acting as a commitment device which ensures that invested capital is remunerated. Whilst protection of the 2020 RCV is important, investor confidence associated with the RCV depends on two things:

- regulatory support and protection of the RCV itself; and
- what is applied against the RCV – specifically the real return and RPI indexation (which equals the nominal return in total)

Therefore to deliver investor confidence and ensure that the sector can continue to attract finance at a low cost Ofwat needs consider its approach to indexation. The current proposal creates a lot of uncertainty for investors given the lack of clarity about what happens to the RCV after 2025. We think greater clarity could be given to investors, whilst reducing bill volatility, by indexing revenues and new RCV by CPI and indexing old RCV by RPI.

### Sludge

#### 1. Do you agree with our proposal to have one separate binding price control for sludge treatment, transport and disposal?

Sludge competition has enormous potential to deliver benefits to customers and we want to be one of the leading players in this market. We consider that this market will only work if there is genuine rivalry between parties. In the context of maximising competitive behaviour we comment below on:

- the form of the control, including service definition; and
- the approach to cost allocation and asset revaluation.

We very much support the proposal for a separate binding control covering the sludge activities. The definition should cover transportation, treatment and disposal as it is the optimisation of this entire system (and its associated costs) that can be achieved through markets. There are short and long term trade-offs between transportation costs and optimal selection of capacity. If transportation were to be excluded and kept in 'network plus', it would presume that the current locations of sludge treatment centres is optimal both now and in the future. This seems unlikely and we think customers would miss out on benefits from a narrow definition.

In relation to cost allocation we think there are two key issues to be addressed:

- ensuring companies can compete on a level playing field, and
- not undermining price competition.

We welcome Ofwat's review of cost allocation in the sludge area and support a targeted revaluation based on the economic value of the underlying assets (age and condition) to support focussed RCV allocation. This distinction in valuations is important otherwise it could distort the market and prevent companies from pricing competitively due to concerns about margin squeeze.

Valuing old assets on a modern equivalent basis is relevant for areas of the value chain where long term replacement rates are relevant but are not where markets and rapid technology advancement

are present. For a level playing field to exist between suppliers (both WASCs and potential new entrants), the assets in use should be valued and priced based on their current condition.

For example, consider a situation where we owned an old anaerobic digestion (AD) site worth £10m on a current condition basis, but the modern equivalent (for latest technology) was £30m. The proposed rules would require us to set prices based on a £30m asset which is only worth £10m in the market. The undesirable results are:

- A. Foreclose the market to purchase assets at cost effective prices from WASCs.
- B. Drive up prices to customers by preventing WASCs making cost effective decisions to replace old capacity when it came due as they would need to write off overvalued assets - driving an incentive to run inefficient for longer than is economical.
- C. Charge customers of sludge processing services more for the use of old assets than they need to.

These effects would distort the market. Moving asset valuation to a current condition basis removes these.

Due to the contemporary nature of sludge assets (the majority of which have been added since privatisation) a focussed allocation sends the best price signals to the market as the discount on the MEAV included in the RCV will be much lower than other areas within the price control (unlike water resources where the assets will predate privatisation).

[2a. Do you agree with our proposal to make a range of cost, capacity and location information available in order to facilitate the identification of trades?](#)

We support the provision of some information to facilitate this market as we consider that current information asymmetries limit the scope for effective trading. Revealing more sludge related information, particularly around capacities, will help parties identify alternative treatment options and opportunities for reducing costs.

However we also note that providing information is not a costless activity and there are two key risks:

- providing too much information could weaken competition because it could undermine commercial behaviour (see 2d); and
- there is a significant cost associated with collecting, assuring and reporting data.

On the latter point, we do not think the information requirements should be extended to other upstream assets such as sewage treatment works. This is because:

- it would not help inform decisions about capacity utilisation;
- sludge investment decisions can be informed by the capacity utilisation of existing sludge treatment facilities; and
- would create a significant data burden which would translate into higher costs.

If Ofwat considers that information from sewage treatment works is needed to inform investment decisions about where to locate sludge works – then it will be important that size of the facility is taken into account. The scope for sludge competition does not extend to 3rd party operators

accessing unmanned sewerage treatment sites in order to remove sludge for processing. Hence the sludge being taken for processing is transported by the WASCs and the scope for competition is understanding where best to treat that sludge. Hence we only need visibility of the capacity and costs at sludge treatment centres

#### 2b. Do you agree that the data should be published on a STC and STW site level?

We support publishing the information on sludge treatment sites as this will allow parties to identify the lowest cost solution.

We think publishing information based on sewage treatment works is unnecessary and disproportionate to the potential benefits. We currently operate over 1,019 sewage treatment works and provision of detailed information for all would be a significant burden generating significant costs. Furthermore information on sewage treatment works is not necessary for the success of the market. Provided information about sludge treatment sites, including capacity, is accessible then companies will be able to identify both (i) lowest cost solution; and (ii) areas for future investment.

#### 2c. Do you agree that the data should be published annually?

We support the annual publication of the data.

#### 2d. Do you agree with the categories of data that we are proposing are necessary and appropriate, as illustrated in the tables? Are any missing?

We agree with the inclusion of data on location of sites, capacity (m<sup>3</sup>/day) and on sludge quality, including organic content and water content. We would challenge that giving very specific information on treatment and transport costs or prices (£s per tonne of dry solids) could put the incumbent at a commercial disadvantage.

An alternative would be to set a commercial gate fee for each sludge treatment centre based on the price of treating and disposing sludge, relevant capital charges and capital return for that works. This would:

- provide a clear price signal to the market to inform decisions about sludge treatment and investment;
- it wouldn't reveal commercially sensitive cost information and hence undermine commercial behaviour;
- it would create an incentive for sewage treatment works to produce optimum quality sludge;
- it would create an incentive for efficient works to optimise their processes and free up capacity; and
- it would allow tankering operations to be optimised based on the combination of transportation costs and sludge treatment charges.



3. Do you agree that the information should also contain details of 'bids' in from entrants, and that there should be guidelines for ensuring that such bids are assessed on a level playing field basis?

As we have explained, we are very supportive of sludge competition – it offers enormous opportunities and also provides Ofwat with the potential to roll back its regulation. In this context we think Ofwat should avoid imposing this obligation on companies. The purpose of creating a market based framework is for letting a market develop and flourish without regulatory intervention.

The current proposal implicitly assumes that all participants do not compete and therefore requires regulatory intervention. This scenario is unlikely and instead intervention should be focused on those that choose not to compete.

We also think intervention distorts behaviours between WASCs, new entrants and providers of other organic waste (OOW) treatment providers. We disagree with guidelines and would rather Ofwat create the mechanisms for a market to operate effectively. If that fails, then Ofwat can use its extensive powers to investigate and intervene on a targeted basis. Ofwat have competition powers to enforce compliance with competition law should that be required. Effort should be spent on designing the market structure and preventing any misaligned incentives or regulatory distortions between incumbents and new entrants. If the economic incentives are well designed there would be no incentive to discriminate against new entrants.

4. Do you agree that the data should be made available centrally through some form of information platform? Do you have any views as to how this might best be managed?

We think information should be made available on a consistent basis between WASCs. However, we don't think an information platform designed by the water and sewerage sector is the answer. The reason being that sludge is a subset of a much wider organic waste market. Designing an information platform to reveal sludge information misses the wider scope for trading that may emerge over time. We can foresee a world where pricing and capacity information becomes more dynamic (at the limit on an hourly basis) with multiple third party operators providing data services to multiple parties. The key issue is to get the right information out, but let the platform remain an opportunity for innovation and markets to deliver.

5. Do you agree with our proposals not to make any changes to the status quo in relation to system operation activities?

We support Ofwat's position and the proposal that system operation accountability should remain with the wholesaler. We will however be looking to develop ideas around this in the future.

6. Do you agree with our proposals not to have any specific financial incentives to support trading in relation to sludge at this time?

We think Ofwat should avoid intervening in this market, beyond setting up the framework (mandating certain information is published and creating the price control). This is because interventions could have unforeseen consequences and also raise the cost of participating in the market.

Our preference is that Ofwat does not apply additional incentives OR trading guidelines. Instead the market should be allowed to develop and if Ofwat observed inappropriate conduct then it should consider either (i) using its CA98 powers; or (ii) apply guidelines in period. This would be a useful regulatory tool that could deliver the same objective without intervention.

## Water resources

### 7. Do you agree with our proposal to have a separate binding price control for water resources?

We are very supportive of Ofwat's proposal for competition for new water resource capacity. Making it easier to access and trade water resources could have significant economic benefits, as previous work undertaken by Severn Trent and others (including Ofwat) has shown.

We think that the current proposals around access pricing on a WRZ basis should help to unlock water resource markets. We are uncertain as to whether the use of a separate binding price control is necessary for the creation of this market. In particular access price will be set using AICs (not costs in the water resource control). Therefore in the context of markets having a separate control with allocated RCV might be unnecessary to unlock the benefits of water resource markets.

### 8. Do you agree with our proposal to implement an offset mechanism to ensure that entrants can recover the cost of new resources appropriately, whilst also ensuring that prices reflect average costs?

We are supportive of this approach. Like Ofwat we think customers will benefit if this mechanism is applied to new resources capacity, rather than displacing existing capacity (which would facilitate inefficient entry and increase costs for customers).

### 9. Do you agree with our proposals to create a market information database and bid assessment framework to allow for the 'bidding in' of third party resource options on an ongoing basis – as set out in the Deloitte report?

We are very supportive of Ofwat's desire to facilitate competition through the provision of better information (although this doesn't necessarily imply more data). There is a need for a greater degree of transparency and an appropriate level of information for markets to operate effectively. Without this information it is difficult for new entrants to evaluate opportunities for entry and more difficult for companies to demonstrate a level playing field.

We believe a market information database would help reveal the lowest cost solution to supply-demand gaps. However it's important that this is kept simple otherwise the volume of data could be significant and it would make it difficult for entrants to assess opportunities. We also think consideration needs to be given to the timing of the publication. Unlike sludge this market will require significantly less frequent information.

### 10. Do you agree that a third party organisation may be best placed to manage the information database?

The provision of information is a critical tool to improve decision making and ultimately deliver efficiencies to the benefit of customers. In the context of water resources what is important is:

- the accessibility of the information – in particular there should not be high transaction costs associated with finding and using the information; and
- the cost of making the data available.

We consider that having a third party host the information platform would clearly make the data accessible. However there is the potential for some administrative costs if the third party needs to be established (with associated governance developed). Therefore we think an alternative proposal would be more appropriate whereby:

- companies publish the data on their websites; and
- either Ofwat or CCW creates a landing page that links to all the company data.

This option would maximise the accessibility of the data but also minimise the cost as existing infrastructure could be used.

#### 11. Do you agree that measures should be introduced to increase transparency and certainty around security of supply for water trading? How can this objective best be achieved?

We are particularly supportive of Ofwat's proposal to increase transparency and certainty around security of supply. In our previous work on water trading we noted that the lack of transparency was one of the barriers holding water trading back. Therefore setting clear expectations around security of supply, including in Water Resource Management Plans, will help facilitate trades as all parties will have a better understanding of the supply/demand requirements and can factor this into buy/sell decisions.

### Allocation of the RCV

#### 12. Do you agree with our rationale for allocating the RCV?

We agree with the rationale for allocating the RCV to sludge. We are less certain that allocation needs to occur for water resources.

The RCV is a fundamental feature of the regulatory framework in the water and wastewater sector. It has helped create a stable regulatory framework which has led to over £116 billion in investment since privatisation. Given its critical nature any proposal impacting the RCV needs to be handled with care.

In relation to sludge, we support Ofwat's position that capital costs should be reflected in the sludge charge to provide appropriate price signals to all parties. Allocating the RCV to sludge on a focused basis will help deliver the objective of market reflective prices. However as we noted earlier, it's important that the revaluation of assets reflects the age and condition of assets. If this doesn't happen too much RCV will be allocated to old assets (based on new replacement prices) and it would reduce the level of price competition and scope for efficiency, which will cost customers in the long run.

In the context of water resource competition, we are less certain whether there is a need to allocate the RCV. This is because the approach to setting access prices is not dependant on the RCV, but rather the forward looking costs. Given the importance of the RCV to investors, proposals that impact the RCV can also have unintended consequences. For example, despite the clear assertions in

the Water 2020 proposal that there is no stranding risk in relation to water resources, we have observed some investors noting that the water resource RCV is at risk. Therefore if Ofwat does not need allocate the RCV to water resources to drive competition, then we would support it being retained in the network plus control.

### 13. Do you agree with our proposed approach for allocating the RCV for sludge?

We are very supportive of the focused allocation of the RCV to sludge given that the approach to pricing depends on this allocation. However as we have stated earlier, it's important that if/when the assets are revalued they are done on a basis that reflects the age and conditions of the assets to ensure a level playing field.

### 14. Do you agree with our proposed approach for allocating the RCV for water resources?

As we noted previously, we think it's critical that access prices send the right signal to promote efficient entry. This is why we are supportive of the approach to allocating the RCV to sludge. We are however less certain that the RCV needs to be allocated to water resources. However if the RCV needs to be allocated to water resources, then we support an unfocused approach.

## Protection of RCV

### 15. Do you agree with our proposal to address stranded asset risks by extending our commitment to protect efficient investment included in the RCV to 31 March 2020?

The RCV is one of the central features of the regulatory framework. It helps to underpin investor confidence by acting as a commitment device which ensures that invested capital is remunerated. Whilst protection of the 2020 RCV is important, investor confidence associated with the RCV depends on two things:

- regulatory support and protection of the RCV itself; and
- what is applied against the RCV – specifically the real return and RPI indexation (which equals the nominal return in total)

Therefore to deliver investor confidence and ensure that the sector can continue to attract finance at a low cost Ofwat also needs consider its approach to indexation. The current proposal creates a lot of uncertainty for investors given the lack of clarity about what happens to the RCV after 2025. We think greater clarity could be given to investors, whilst reducing bill volatility, by indexing revenues and new RCV by CPI and indexing old RCV by RPI.

### 16. Do you agree with our assessment that there is no prospect for stranded assets due to the proposed form of control for sludge and water resources for the 2020-25 period?

Water resources - by applying a revenue control we consider that there is no prospect for stranded assets for the period 2020-25.

Sludge - the scope for stranding over 2020-25 would seem to depend on a number of factors including the quality of the information being shared by market participants and how technology develops. Whilst the prospect for stranding could be low, we don't think it is zero and we could envisage scenarios where assets are stranded. For example a third party could enter the market in

2024 with new treatment that generates additional energy – this could displace any new capacity built by the incumbent.

17. Do you agree with our proposed approach of an income guarantee recovered through the network plus control for protection against the risk of stranding, if a mechanism is required? How do you consider that such a mechanism could be designed to provide a simple, transparent, largely ex ante mechanism that preserves incentives for efficiency?

We are very supportive of Ofwat's efforts to mitigate risk associated with sunk investments at 2020.

Water resources - we actually think Ofwat might not need a separate mechanism given the application of a revenue control (and our expectation that it would operate in a similar manner to WRFIM, albeit the revenue shortfall or excess would be recovered via the network plus control given other statements in the document).

Sludge - an ex-ante revenue guarantee based on the (i) fixed element; and (ii) the implied volumetric rate from the PR19 FD sounds the most sensible and pragmatic solution to deliver a price control with guarantee on the RCV

### Access pricing

18. In relation to water resources, do you agree with our proposals to implement an approach based on the average cost of providing 'network plus' activities?

We are very supportive of Ofwat's approach to access pricing. For upstream entry to occur, we agree that its vital efficient entrants can compete on level terms, which includes the ability to access an incumbent's pipes to supply their customers. This is something we strongly advocated in our contribution to the market place of ideas (see Options for access pricing methodology – Oxera).

Given the need to access an incumbent's network, the proposal to set access prices by reference to the average cost of the incumbent's network plus activities makes a lot of sense. Whilst further disaggregation of the network plus control is possible (i.e. not using the average) we think locational signals could be better set through connection charges.

19a. In relation to access prices for water resources, do you agree with our proposal that companies should be responsible for calculating and publishing these?

We very much support Ofwat's proposal that incumbents should be responsible for calculating access price.

Promoting markets for new water resource require a number of reforms, most importantly access prices that reflect forward looking costs and better information. At present only incumbents have the data necessary to:

- forecast long term demand under different scenarios; and
- calculate the long term supply capacity under different scenarios (eg climate variability).

This information asymmetry requires that incumbents are responsible for setting access prices.

19b. Do you agree they should be published by water resource zone, with network distribution and treatment costs separately identified?

Water resource markets have the potential to promote productive and dynamic efficiencies through the better use of water resources. However to realise these efficiencies it's important that entry occurs in the right places – specifically where there is a projected shortfall of water resources.

We are therefore very supportive of Ofwat's proposal for locational based signals, using water resource zones as the central component. This is something we advocated in our work on access prices (see market place of ideas) and was something that the Cave Review proposed when considering the scope for upstream competition.

However we would also urge that geographical averaging of prices for end-users is maintained. The tension between localised access prices and averaged end-user tariffs has been managed in other sectors to great success. There is no reason why it should not be possible in the water sector.

In terms of specific charge components, we consider that the charge should reflect the form of competition that is available under the legislation and licence conditions.

20. In relation to water resources, do you agree with our proposals to implement a mechanism that offsets the difference between the LRIC (or potentially the AIC in the absence of LRIC data) of new resource and the prevailing average cost of resource?

We support the proposal to implement a mechanism that offsets the difference between the LRIC of new resource and the prevailing average cost of resource.

For upstream entry to occur, it is vital that access prices enable efficient entrants to compete on level terms. Offsetting the difference between LRIC of new resource and the prevailing average cost of resource would ensure that third parties with LRICs less than the incumbent would be able to profitably enter the market. This will help deliver the lowest cost water to customers and thereby reduce bills relative to the counterfactual of no entry.

We also support Ofwat's position (page 22 of the appendix) that care needs to be taken in how the AIC is measured, otherwise there could be inefficient entry. This would arise if the mechanism incentivised parties to supply new resources when there is no need. Therefore additional measures/rules should be adopted to promote entry only when there is a need for new capacity. For example it might be helpful to have additional rules over how the AIC is measured. In particular the AIC used for access pricing should be based on a stacked schemes that a company is proposing to build over the relevant planning period (which could be 5-10 years).

21. Do you further agree that it is the incumbent's, rather than the entrant's LRIC, that should form the basis of the payment, in order to provide a stronger incentive for entry?

We support Ofwat's proposal that access prices should be set on the basis of the incumbent's LRIC rather than the entrant's. This will help deliver a price signal that promote efficient entry (i.e. cheaper water to be supplied). This is because the entrant would only be able to profitably enter the market if its LRIC is lower than the incumbent's.

22. In relation to sludge, do you agree that price and non-price terms should be the outcome of commercial negotiation, supported by the cost or price and capacity information previously set out?

As we have noted in our response, we are very supportive of Ofwat's proposal to promote sludge competition. We think this is a market where significant customer benefits are likely to be realised through better use of capacity and new technologies. We recognise that it will require some regulatory intervention (i.e. the price cap) however we fully support the principle that the market (incl. contractual terms) should develop through commercial negotiation as opposed to regulation.

23. Do you support our proposals to develop high level guidelines as to how rival offers in relation to sludge treatment, transport and disposal should be evaluated?

One of the key impediments to sludge markets is information asymmetry. To make the optimal decision about how sludge is treated it is necessary to understand (i) what options exist; and (ii) the price of using alternate options. Provided this information is published, companies will be able to identify the lowest cost solution. This solution could involve treating sludge themselves, or using another company or third parties facilities. The key point is that provided a company can identify a lower cost solution it will have a strong financial incentive to adopt that solution.

In light of the strong financial incentive we don't think trading guidelines are needed. Whilst we recognise Ofwat's point that companies are monopoly sellers of sludge, there are strong financial incentives to procure the lowest cost solution. Therefore we do not think guidelines are necessary, at least at this stage. Instead Ofwat might consider closely monitoring the market to understand if there is an issue before deciding to intervene.

### **Making greater use of direct procurement**

24. Do you agree with our proposals relating to the use of direct procurement on behalf of customers?

See note.

25. Do you have any views on our specific proposal to set a £100 million threshold above which point we would expect companies to procure at market on a standalone basis?

See note.

### **The implications of making better use of markets**

26. Do you agree that our proposal for four binding wholesale price controls should apply to companies whose area is wholly or mainly in Wales, as well as to companies whose area is wholly or mainly in England?

We think having a consistent regulatory framework across England and Wales is beneficial in that it:

- maximise the number of comparators available for benchmarking, which would improve the robustness of the wholesale econometric modelling and the setting of performance targets for horizontal ODIs; and
- reduces the cost of regulation per customer.

However we strongly respect the decisions of the Welsh Government to choose the form of regulation that should apply to its citizens and we will work with whatever framework is decided upon.

**27. Do you agree with our initial view that the network plus controls for water and wastewater and the water resources controls should be total revenue controls?**

We are very supportive of revenue controls for the network plus services – this is because they will help reduce risk and ultimately keep customer bills low through a low cost of capital.

In the water and wastewater sectors one of the key cost drivers is the cost of capital. A significant proportion of customers' bills over the 2015-20 period – around 20% or about £80 average per customer per year – will be associated with financing new and past investment. Maintaining a low cost of capital is critical to keeping bills low. In the context of the form of control, the use of a revenue control or a price control can have a significant impact on risk and hence the WACC.

Under a price control companies are exposed to changes in demand and volume, whereas under a revenue control companies are not exposed to that risk (instead it sits with customers). Setting network plus and water resource revenue controls does not expose companies to additional (volume and demand) risks. Given that these are most likely to be influenced by weather patterns and are outside company control, this proposal will reduce risk exposure and ultimately keep bills lower.

We also consider that the revenue controls should provide an incentive for companies to back-bill. We believe that customer want us to pursue bad debt and back-bill customers as this means the cost of services are more evenly spread. At present there is a disincentive to back-bill given the rate of bad debt exceeds the additional revenue that retail collects. Therefore we would support a revenue control with some adjustment to incentivise back billing and which would allow companies and customers to share the benefit. This could also include a requirement that companies can only claim the additional revenue if performance in related areas, such as bad debt, is at the UQ level.

As part of the market place for ideas we are proposing to investigate in-period incentives for PR19, which would include back-billing.

**28. Do you agree that future investment in relation to sludge treatment, transport and disposal should be exposed to volume risk and, accordingly, what are your views regarding the appropriate form of control in this area?**

We support the principle that of applying a price control to sludge. Unlike water resources, we consider that sludge volumes are more likely to be driven by gains and losses in market share. Therefore applying a price control (instead of a revenue control) will:

- incentivise companies to compete because they will get to retain the difference; and
- ensure that customers do not pay for inefficient investments as customers will only pay a fixed price.



### 29. In your view, how should new investments be remunerated in the sludge and water resources controls from 2020?

We believe that new investments should be remunerated by a return on the RCV. As we have noted the RCV is one of the central features of the regulatory framework and is well understood by investors. It helps to underpin investor confidence because it represents a commitment device which ensures that invested capital is remunerated.

Whilst there will inevitably be some risk of stranding for new investments (at least for sludge), there will still need a need for significant investment in these areas. Maintaining the use of an RCV, albeit reported separately to old RCV, will give investors' confidence that provided incumbents' volumes reflect forecast they will be able to earn their return.

### 30. How can we best ensure that long-term contracting arrangements are not dis-incentivised – and that any continued application of a return on RCV approach for incumbents is on a level playing field with third party providers?

The most important tool to promote market based solutions is the establishment of the price cap. This will incentivise companies to look beyond their borders.

We also consider that assessing the financeability of the sludge control on a stand-alone basis would also help promote a level playing field as it would help promote charges that reflect the costs that a standalone business would need to recover.

## Incentivising monopolies to discover and reveal information on efficient costs

### 31. Do you agree with our proposal to retain our RBR approach for PR19?

We are very supportive of the Risk Based Review (RBR). This is something we advocated following PR09 after observing that the CIS menus did not having the incentive properties that were predicted. For the RBR to deliver the best outcome for customers, we think Ofwat needs to consider:

- the size of the financial rewards; and
- sharing information (WACC and cost models or key components) in advance of submission to promote more effective customer engagement.

The RBR will deliver the best outcome for customers if there are strong financial incentives that reward companies for taking the risk of submitting challenging plans. At PR14 the size of the incentives was unknown and Ofwat had the luxury of being able to set quite a small reward, particularly when compared to the size of the rewards in energy. Looking forward we think Ofwat will get a much stronger response to the RBR, particularly at Board level, if it sets a much stronger financial incentive for enhanced, similar to Ofgem.

The RBR will also likely to be more effective if Ofwat shares in advance of business plan submission its expectations about the WACC and cost models. This is because the WACC and cost models in particular have such a strong impact on bills. By providing this information in advance we can more accurately present our customers scenarios that reflect what priorities could be achieved under different affordability constraints.

32. Do you agree with our proposal to reflect current performance in our RBR assessment (and for CCGs to consider this as part of their report?)

We agree that the credibility of the risk based review is critical to its long term success. If stakeholders do not view enhanced companies as genuinely being top-performing companies then the reputational benefits will be diminished significantly.

We therefore support Ofwat's proposal that current performance should be reflected in the RBR assessment. We think this proposal will help maintain the credibility of enhanced status. This assessment should make a distinction between:

- systemic poor performance and poor performance on a small number of measures with very good performance across other measures; and
- how the company has responded including via engagement with its customers; and
- how it plans to improve performance.

33. Do you agree that the RBR assessment should consider the extent to which the business plans are part of a longer term plan?

We are very supportive of increasing the focus of the assessment to the long term. One of the biggest challenges confronting the sector is ensuring that we are on a sustainable course. This means delivering the service improvements customers wish to see and a healthier environment, all at an affordable price, and in a way that the sector can continue to be financed in the long term.

We therefore welcome Ofwat's desire to take into consideration long term planning, when assessing business plans at PR19. In making this assessment we think Ofwat will need to draw on a range of evidence including:

- Engagement with customers about the medium-long term priorities, including how those priorities are balanced against affordability constraints;
- Challenge from CCGs about how companies reflect customer views about the long term in business plans;
- Assessment of total system risk/resilience in the medium-long term and what steps companies plan on taking to maintain their outcomes;
- Wholesale costs that reflect the upper quartile efficiency level;
- Incentives that reward companies for outperforming when delivering the service levels customers want; and similarly penalising companies when they fail to deliver the services customers value; and
- High quality Board assurance about the long term viability of the plans.

### Assessing cost efficiency

34. Do you agree that the consideration of disaggregated cost models is appropriate given the price control structure proposed?

We are very supportive of Ofwat's use of benchmarking to assess and set cost allowances, including the application of a UQ efficiency challenge.

Assessing the efficiency of expenditure is not a straightforward exercise, particularly in a sector where price reviews determine revenues in excess of £40 billion. Econometrics have become the established way of comparing efficiency as it allows Ofwat to efficiently benchmark performance and reward high performers whilst challenging poor performing companies to improve.

We support the position that top-down econometric models will need some separation into the different controls. The econometric modelling should seek to build on the successful PR14 models and:

- more explicitly take account of the underlying level of service (output), as this will help all parties assess whether additional cost allowances are required for enhanced levels of service;
- should not cap the frontier company, otherwise it could reduce incentive to submit challenging plans;
- reflect changes to long term needs such as adapting to climate change; and
- not create an overly burdensome data requirement.

It will also be important to undertake some form of high level review 'in the round' to ensure that the efficiency challenge is sensible when viewed in aggregate, particularly if the financeability assessment is being undertaken in aggregate. This is particularly relevant in relation to the resource control. Many costs in resources are uncontrollable (e.g. EA fees) and they are not evenly applied across the UK so simple benchmarking would not reveal inefficiencies. We also note that other costs, such as MOSL fees are levied in this way and it would be useful for the modelling to separately adjust for regulatory fees.

We also consider that Ofwat should continue with its approach at PR14 and set a UQ efficiency challenge. Whilst Ofwat could consider adopting the CMA's approach of an average efficiency challenge with an on-going annual target, we the UQ challenge better resonates with stakeholders.

### 35. Do you agree that the development of detailed cost allocation guidelines is appropriate?

We are extremely supportive of Ofwat issuing new cost allocation guidance that supersedes all previous iterations and versions.

A large challenge confronting companies is that cost guidance has been issued piecemeal without a comprehensive update. This requires companies to maintain a corporate 'memory' and ensure that all updates are identified and incorporated. This can lead to mistakes if an element/update is missed. Often this also requires judgement, where different guidance documents appear to conflict (as occurred in relation to CIS). Therefore we would welcome complete and thorough guidance.

We also note that there are areas where it may be appropriate for different measurement between companies, so the guidance should include requirements on companies to make clear how items are measured, not just what is included where. Where Ofwat is proposing to use comparative ODIs, then there should be a comprehensive audit of how these performance levels are measured and issued so that the sector can look to improve.

Finally it's important that the timing of the guidance is provided early to ensure companies have sufficient time to ensure cost capture systems can be aligned.

## Encouraging a long term approach

36. Do you agree with our proposal to retain the current timings of our price controls that is not change the duration of wholesale price controls, not to stagger wholesale water and wastewater price controls and not seek to further align the timing of controls with other planning processes?

The length of the price control needs to strike an importance balance between providing stability for long term investments, whilst minimising the risk that the economic fundamentals underpinning a determination change. In light of the proposals around water resources and sludge, we think there is merit in Ofwat considering the pros and cons of a longer period, similar to Ofgem's 8 year control.

37. Are there any other measures, not considered above that could help to encourage a longer term approach?

We welcome the commitment to work "closely with Defra, the Environment Agency, Natural Resources Wales and companies to align our price control processes in the run up to such reviews with other planning cycles and ensure that companies have the greatest clarity possible." We also think that Ofwat needs to work closely with the DWI to understand the long term challenges facing the sector.

It would be useful to understand in more detail how aligning the different planning cycles would work in practise. For example this could be achieved through a published agreed statement of principles and guidelines about coordination of statutory submissions and processes.

We also think Ofwat is right in setting out the challenge about long term planning, rather than trying to come up with the answer. The responsibility should be on companies to demonstrate how they are promoting a long term approach and we expect a range of approaches will be trialled at PR19. At the end of the next price review Ofwat should consider the different approaches and if there are some stand out methods, consider promoting those for PR24.

## A more responsive regulatory framework

38. Do you agree that we should amend the licence to allow for in period adjustments for some or all of the following: outcome delivery incentives, revenues and cost sharing?

We strongly support taking rewards and penalties in period as this strengthens the incentive of delivery for customers. We requested this licence change at PR14 and it's been hugely benefit to our company and customers because it strengthens the incentives. For example we have seen a step change in performance against most ODIs as reported in our interim result. The focus on performance creates greater urgency in delivery of enhancement investment and greater management focus on performance.

We support the license changes for ODIs and revenue (but not CPI indexation). We can also see benefit in having the rewards and penalties from totex cost sharing being made in period. However this would need to be applied flexibly so companies can manage (i) bill volatility; (ii) change in the profile of expenditure. This would suggest that we should avoid applying a WRFIM type rule and instead allow companies to take more ownership about how they make adjustments, given the objective of bill stability.

## CPI indexation

Questions 39 to 43 – see our attached response

## Impact of the balance of risk and reward on the cost of capital

44. To what extent does the current balance of risk and opportunities vary across the proposed wholesale controls and how does this impact on the cost of capital?

While there are a number of factors that mean that risks and opportunities will vary for different parts of the value chain, this does not have straightforward implications for assessing the cost of capital. The key issue in terms of cost of capital impacts is the extent to which there are materially different levels of systematic risk associated with different activities.

The PwC report presents the view that systematic risk is higher for sludge as compared with wholesale activities as a whole. We do not consider that PwC's analysis provides an adequate basis to draw this conclusion. PwC's view is largely based on the assessment of (i) energy costs; and (ii) operational leverage.

In terms of energy costs, a key concern we have is that the PwC assessment does not provide a robust basis for concluding that higher energy costs in sludge translate into a higher beta. PwC's conclusion seems to rest heavily on a highly simplified comparison between the average identified equity betas of two sets of companies that are identified as having different energy use levels. However, without examining the characteristics of these companies (and differences between them) in more detail, this provides an extremely limited basis for comparison. There are many factors that could materially affect identified equity betas (including gearing levels, given that the analysis considers equity rather than asset betas) and simply attributing this high level difference between groups to differences in energy consumption does not provide a robust basis on which to draw and/or support the conclusion reached for sludge.

We consider that much more analysis would be needed before any robust conclusions could be drawn from this analysis if Ofwat chooses to adopt this methodology.

We also consider that the level of relevant energy costs for the assessment of systematic risk in sludge requires further attention before robust conclusions can be drawn. In particular, given the use of sludge as an input into energy generation, the impact of energy price movements on returns will depend on the net impact of these movements on revenues as well as costs. In line with this, we would question the extent to which volatility in the UK industrial electricity price index would impact on relevant power costs given energy generation levels and the implications this has for energy self-sufficiency.

We also have concerns with the analysis of the relation between asset beta and capital intensity. The analysis by PwC is limited and ignores other factors that could be impact on the asset beta – although PwC does acknowledge this point.

Overall we think considerable more analysis is required before concluding that the asset beta of sludge is materially different to the wholesale business. In the absence of this evidence we would

support applying the same asset beta, ahead of the consideration of the impact that market and incentive reforms may have (see below).

#### 45. To what extent would our proposed market and incentive reforms impact on the balance of risk and opportunities and the cost of capital and whether this would vary across the proposed wholesale controls?

Under the proposed reforms a wide range of different issues could arise, but for the purpose of this response we focus our comments on the proposed market and incentive reforms related to sludge. We will comment on other potential issues (for example, associated with the development of ODIs) as further proposals are developed.

In terms of the sludge proposals, there look to be two key issues to consider. Firstly, as recognised in the consultation, the movement to a price cap increases the intensity of regulation and involves an overall increase in the risk borne by companies as opposed to customers. That is, companies will be exposed to volume risk, including volume risk that stems from overall movements in market conditions (rather than gains and losses from competition, which are discussed below).

We agree that this change has the potential to increase systematic risk, and thus increase the appropriate cost of capital for the sludge business (over and above the level that might be identified from separating the sludge control but retaining the current form of control).

The other key potential source of impact on risk and the cost of capital is from competition. We agree with PwC that it would seem unlikely competition will impact on systematic risk. This is because investors can diversify their portfolio and therefore not be exposed to a reduction in overall returns.

However, competition does introduce greater downside risks for companies, and this means that there will have to be correspondingly significant opportunities for upside benefit for companies to be able to expect to earn their cost of capital. The appropriate way of addressing this will depend on the overall package of arrangements that is developed, but consideration should be given to the use of an uplift on the WACC, and more generally to the importance of providing opportunities for upside benefits to be realised.

We do not agree that this issue arises only after 2025 when the likelihood of lower returns will be greater, as expectations of future returns will be relevant for decisions concerning the provision of sludge capacity from the point at which the reforms commence (and RCV protection is removed). We consider this important to recognise. While asset lives in sludge are much shorter than those in water resources, sludge investments can nevertheless be long-lived by the standards that would be considered to apply in most sectors (water resource asset lives are often extremely long-lived and it is this that makes sludge asset lives look relatively short). Investment incentives should be considered therefore from the outset of the reforms.

### Customer engagement and outcomes

#### 46a. What does good customer engagement look like?

We are fully supportive of the challenge from Ofwat that companies need improve how they engage and use customer views. In our strategic framework we have challenged ourselves to embed

customers at the heart of all we do. And this means we'll need to improve the way in which we engage with customers, through improved insight and understanding of what's important to them.

In terms of "what does good customer engagement look like" – we don't think there is a simple answer to this question like there is when assessing other aspects of company performance. We know what the outcome of good customer engagement looks like – which is a real understanding of what customers want and value over the short, medium and long term. How this outcome is achieved will require that companies try new methods and continually adapting their tools and processes. We think some of the characteristics of good customer engagement include:

- the use of research that openly explores what customers want – or could want, as opposed to starting with preconceived views or constrained question. Importantly companies need to accept what is heard back;
- the use of new channels to access different demographics, including digital channels
- the use of new methods, such as experiments to reveal customer preferences rather than simply asking customers directly about their preferences;
- the use of new data sources, rather than just utilising surveys/focus groups and responses to consultations. This includes analysing information generated from everyday interactions;
- better contextualisation of subjects and choices. For example, customer views on ODIs first had to be placed in the context of how they would work in reality, not simply the theory behind them. Issues should be presented so that customers can relate to them easily and can draw on their own experiences.
- on-going process which provides companies with an opportunity to learn and develop plans, commitments and outcomes that reflect customers' long term wishes.

#### 46b. What are your views on the principles outlined above?

We are very supportive of the principles relating to the role of companies and CCGs. Below we share our specific thoughts on each of the key points raised in the consultation.

##### Role of companies:

- We agree that it should be the responsibility of individual companies to understand the priorities of their customer base.
- We agree that multiple sources of evidence should be used to form a detailed view of customers' priorities and views and that a reliance on stated preference measures needs to be reduced (although stated preference will still form an important part of the evidence base).
- We agree that sources of information should be broad and include the everyday interactions that we have with customers.
- We agree that we need to ensure that different types of customers are consulted and engaged and on range of subjects from the immediate, short term through to long term issues.
- We agree that engagement should be a two way process with customers being part of an active two way dialogue.

#### Role of CCGs:

- We agree that the role of the CCG should be to challenge and assure the companies approach to customer engagement and not act as a substitute for them.
- We support the approach advocated to setting expectations of CCGs as to their role in the quality of their challenge and assurance.
- We suggest that CCGs take their own view as to the extent to which they require comparative information about other companies' customer engagement in order to take a view on their own (although we support Ofwat making the horizontal PC/ODI data accessible).
- It's important that CCGs are not seen as a substitute for customer engagement, particularly after the RBR.
- Similarly it's important that CCGs are not seen as a substitute for Board ownership - the role of CCGs is to challenge, but the Boards need to own the plans. So we welcome your statement that a CCG and company disagreeing is not a failing of the process provided that the rationale is well documented.

#### Composition of CCGs/Transparency:

- We agree that companies are best left to determine the composition of the CCG.
- We agree that CCWater representation on CCGs is important for the credibility of the challenge groups.
- We think transparency about the appointment process, funding and governance is equally important to promote credibility in the CCGs.

#### Collaboration of CCGs/Publication of information:

- We believe there is value in CCGs and their chairs working together to establish better ways of working (such as sharing lessons on governance).
- However, when it comes to best practice customer engagement we believe this is a matter for individual company CCGs to work with companies directly, rather than seeking to develop, for example, best practice approaches to any particular research challenge.
- We add this caveat as we believe that it is down to individual companies to interpret and innovate around customer engagement and be rewarded for those efforts.
- For this reason we support the sharing of information between a company and its CCG but would reserve the right for companies to decide what publication is made public or shared with other CCGs.
- Ultimately the RBR is a competitive process so care needs to be taken not to undermine that competition.

#### 46c. How could companies draw on good practice from within and outside the sector?

The spreading of best practice can occur through a number of ways. For example:

- recruit talent from other sectors that have a strong track record of innovative customer engagement;



- use of tendering to bring in other organisations that can offer an alternative perspective of how to reveal customer priorities;
- compare performance against wider benchmarks (i.e. not just water);
- share more comparative information about company approaches at the conclusion of each price review (this could be shared informally).

We don't think Ofwat should be responsible for spreading best practice, beyond setting its expectations. Responsibility for identifying and adopting best practice sits with water companies and companies that are good at this can get obtain a competitive advantage.

#### 46d. How can companies make use of revealed preference techniques and information obtained in their day-to-day interactions with customers to develop a richer set of evidence of customers' needs and requirements?

We think one of the principle challenges facing companies will be how they integrate information from a range of different sources to develop a clear picture of customer priorities.

As we have commented earlier in our response, we have challenged ourselves to improve the way in which we engage with customers. This will require applying new tools and methods to reveal customer priorities. We think it's highly likely that this will generate unusual results and potentially conflicting results. Therefore validating the results will be crucial to ensuring that we deliver the priorities value most. We think this validation can occur in a number of ways, for example:

- seeking third party assurance about the different approaches applied, particularly innovative methods;
- applying iterative rounds of testing and refinement using as many means of engagement and information exchange as the companies deems practical;
- engaging with other organisations (not just water companies) to test both (i) the way the tools are used; and (ii) the results to sense check them.

Ultimately we think some judgment will be required. Therefore it will be important that companies have both (i) there is sufficient evidence to justify the position; and (ii) clear audit trail of how/why they have made decisions.

#### 47a. What are your views in relation to our proposals on future CCG remit; scope; timetable; governance arrangements; and membership?

Remit and scope - see earlier answers.

Timetable - we support the submission of the first report at the time the companies submit the business plan. We also agree with the notion of the second report but it's important that this doesn't creep into areas outside CCG remit (e.g. it should focus on how we have taken into account customers' views and represented those).

Membership - we agree that companies should choose the membership that would deliver the most effective challenge.

Governance - we agree that companies should consider the most appropriate governance. What is critical is that the governance arrangements are transparent.

47b. In relation to the quality of a company's customer engagement, do you agree with the above list of issues that should be covered by the CCG report?

For the most part we agree with the list, although there are two areas which merit further consideration (i) performance related payments; and (ii) engagement about solutions.

We welcome the challenge from our customers on performance but consider that rewards or penalties should be as per the risk reward framework and existing GSS mechanisms agreed with our customers and Ofwat at PR14. We recognise that there could be exceptional circumstances that warrant deviating from the agreed framework, but in general we think companies and Ofwat should strive to get the framework right – for example our current rewards are calibrated to ensure 50% sharing with customers, consistent with the totex cost sharing. This is because a clear framework with clear incentives will drive the right behaviour and deliver the best outcomes for customers.

We also question the extent to which companies should be engaging with customers on options/solutions to deliver the desired outcomes. Although we recognise that in some areas, such as supply-demand balance, the applicable options are an emotive topic and therefore could warrant specific conversations. This however should be up to the company rather than being mandated across the board.

Our concern is that the requirement could creep into other areas. For example it would seem unusual for companies to engage with customers on their preferred option to minimise discolouration complaints, such as changing the chemical composition of lime. Instead companies should be engaging on what is the right level of performance based on options around pricing and bill impacts. We therefore think companies should choose whether they engage with customers on specific solutions rather than having it mandated.

47c. What are your views on the division of responsibilities between CCGs and Ofwat?

We support Ofwat's proposal that the CCG should be focused on challenging how companies have engaged with their customers and reflected that engagement in the business plan.

We think that if these activities are undertaken appropriately then Ofwat should be able to focus on assessing the efficiency of the cost proposals and the balance of risk and reward (as opposed to intervening in relation to the scope and level of PCs and ODIs).

48a. What are your views on our proposal to facilitate more collaboration between CCGs?

We support collaboration between CCGs on issues of governance and process.

We are uncertain whether collaboration should occur at a more detailed level – such as how companies are revealing customer priorities. We can see benefits in collaboration (i.e. sharing best practice) however it would also reduce the competition between companies to develop the best plan. Therefore a balance needs to be struck between these competing objectives.

We also think recognition needs to be given to confidentiality agreements between the CCG and companies. We also have concerns on the frequency of the workshops, our CCG chair is contracted for a limited number of days per year, has a number of other commitments and their time will be best utilised challenging how we engage with our customers and how we reflect the priorities in our plans. We think this needs to be a consideration when developing the programme of CCG / Ofwat workshops.

**48b. What are your views on our aspiration to publish information on the WACC and outcome RoRE ranges early?**

As per question 31, we are very supportive of Ofwat sharing information such as the WACC, RORE range and cost models ahead of business plan submission.

Sharing this information whilst plans are being developed will allow companies to more accurately engage with customers about how priorities should be balanced. This is because the WACC and cost models in particular have such a strong impact on bills. By providing this information in advance we can more accurately present our customers scenarios that reflect what priorities could be achieved under different affordability constraints.

**48c. Without inserting ourselves between companies and their customers, what else could we do to incentivise and encourage good quality customer engagement?**

We think Ofwat is right to put the onus on companies to develop great customer engagement. Ofwat can still play a really important role by supporting companies that deliver ODIs.

The introduction of outcomes and ODIs was a revolutionary idea for water regulation and we recognise that Ofwat faced significant opposition. We can now see that Ofwat was right to introduce these incentives because they are focusing company performance on services that customers value most. At Severn Trent this has translated into improved performance across a number of outcomes at a very low cost.

Looking forward we think there is a risk the sector could come under pressure to abolish ODIs or reduce their strength – this would be a mistake as customers would suffer. Therefore it will be important for the credibility of the regulatory regime that Ofwat comes out strongly in support of companies that over-deliver on ODIs during this control period.

**49. How can the outcomes framework encourage a longer-term approach? Should we encourage, or even mandate, that certain measures - for example asset health – span more than a single regulatory control period?**

We are very supportive of Ofwat's desire to promote a longer term approach to (i) its regulation; and (ii) planning by companies. This is critical because the water sector is characterised by assets that span multiple control periods. In this context we think there are opportunities to enhance long term planning through:

- Articulating what level of resilience/asset health is reflected by the totex models. Depending on customers priorities it's possible that customers might want a higher level of (asset/network) resilience than is currently offered. To support the delivery of this,

companies may need to make special cost claims to increase investment. Therefore revealing the embedded level of resilience from the models will help companies engage with customers and make informed investment decisions.

- Long term outcomes, PCs and ODIs - we can see the benefit of such measures. However if performance targets span multiple AMPs and funding doesn't then it changes the risk and reward balance. Therefore any framework that accommodates multi AMP ODIs should be linked to a commitment on the funding.
- Mandated PCs and ODIs - there will be a need to mandate those PCs and ODIs that Ofwat will use for comparative purposes. However we do not think Ofwat should mandate additional measures. Adopting a one size fits all approach would reduce the scope for innovation and prevent new leading indicators from being designed. Instead we think Ofwat should be prepared to intervene if there is insufficient coverage and assurance about the asset health measures

**50. What are your views on the proposed contents of our November 2016 consultation on outcomes (balance of bespoke versus comparative measures, and role of comparative information)?**

We think it's really valuable to have advance warning about upcoming consultations. For the November consultation we think it should cover:

- the split between bespoke and comparative ODIs;
- the timetable for when the list of comparative ODIs will be defined ;
- expectations about RoRE ranges;
- how PCs and ODIs interact given separate sludge and water resource controls; and
- standardising the measurement of comparative PCs and ODIs.
- wholesale cost assessment – with a focus on (i) the models and (ii) treatment of frontier performance – ie, as per the December consultation – a focus on the potential not to cap the results of the frontier companies

**51. What are your views on our proposal that companies submit the definitions – but not the targets or any associated incentives - for their performance commitments to us in early 2018 before they submit their business plans?**

In relation to outcomes, we think it's important to differentiate between the standardised PCs/ODIs and the bespoke measures.

For the standardised measures, we fully support having the definitions agreed early – ideally by 2017. This is important because if there are changes in the definition, it could impact the resulting service level and therefore:

- companies will need time to ensure they have appropriate plans to deliver to UQ or higher service levels; and
- companies may need to reengage with customers in relation to forward looking plans (i.e. because comparative rankings could change and hence customers might have different expectations about the service level that should be provided).

For non-comparative PCs and ODIs we don't think there is a need to provide the definitions except at the time of submission. This is important because the definition of these measures could evolve through iterative customer engagement and testing. Therefore it would be unhelpful to be bound to a certain definition before we have finished our customer engagement.

[52. What are your views on our proposal for a licence modification to allow for the in-period payment of outcome delivery rewards and penalties?](#)

As per question 38, we strongly support the use of in period ODIs to strengthen the incentive of delivery for customers. We requested this licence change at PR14 and it's been hugely benefit to our company and customers because it strengthens the incentives. For example we have seen a step change in performance against most ODIs as reported in our interim result. The focus on performance creates greater urgency in delivery of enhancement investment and greater management focus on performance.

### Licence modifications

[53. Do you agree with our summary of potential licence changes and the process for achieving these outlined in section 9.1 above?](#)

We fully support 4 out of 5 of the licence changes. We do not support the amendment relating to the application of CPI indexation.

We also note that the licence that underpins each water company is a cornerstone of the regulatory framework. Like the RCV, investors regard the licence as one of the defining features of a company. Licence stability helps to minimise (regulatory) risk and ultimately allow companies to access cheap finance, thereby keeping bills low whilst allowing service levels to improve. It is in this context that we think Ofwat needs to be mindful about the volume of licence changes, particularly those that have a knock-on impact on its approach to remunerating returns.

[54. Do you agree with the next steps for establishing the necessary data for the 2019 price review outlined in section 9.2?](#)

The timetable for the review of costs and assets seems sensible. We emphasise our position that any asset revaluation needs to reflect the age and condition of the assets

[55. Do you agree with our indicative timetable for the Water 2020 programme?](#)

We are very supportive of the indicative timetable for Water 2020, except that relating to CPI indexation.

We also think that there are opportunities for further transparency around:

- key process and work streams within Water 2020 such as issuance of the financial model;
- approach to risk and reward including debt indexation; and
- the "further November consultation" that is listed but not specified.

This information will help us develop our internal plans and resources. Furthermore additional clarity about the November "further consultations" would be helpful.

Finally we are receiving a number of “ad-hoc” requests for data. Although these requests state that the information is to be provided on an unassured and unaudited basis (given very tight timeframes), we are increasingly concerned about how this data is being used. For example is it feeding into the company monitoring framework? We would like to see more structure to how data is being requested and reasons for sharing, with appropriate lead in times so we can assure the data.