Wessex Water
Draft methodology response

This document contains our full responses to the draft methodology consultation, excluding questions relating to bioresources.

Chapter 2 - Regulating through the price review

2.1 Do you agree with the challenges facing the sector and the ambitions for PR24 we have identified?

Strongly disagree

Key messages

- The draft methodology significantly underestimates the scale of the challenges facing the sector. Whilst the identification of the areas of importance are correct, the quantification of the size of these issues appears underweighted in the methodology.
- Whilst we support the stated ambitions so far as they go, we believe these need to go considerably further and be backed up by significantly improved detailed proposals in some areas in order to be effective.

Additional points

- We believe that the industry can go further in terms of aligning with net zero targets but this is not reflected in the draft methodology.
- The methodology should provide for approaches that: both adapt to and mitigate climate change, focus on sustainable abstraction, address nutrient neutrality, and use appropriate measures for affordability, anything less than this will not allow for the development and maintenance of an efficient and economical system of water supply.
- Some of the proposed performance commitments will drive perverse behaviours that undermine the protection and enhancement of the environment.

We believe that the draft methodology significantly underestimates the scale of the challenges facing the sector. Whilst the qualification of the areas of importance are correct, the quantification of the size of these issues appears underweighted in the methodology.

Again, whilst we support the ambitions, so far as they go, we believe they need to go considerably further and be backed up by significantly improved detailed proposals.

Challenges facing the sector

We have committed considerable resource to developing options to address the issues around environmental regulation and have engaged with Ofwat, the Environment Agency, and government over the last two years to help find a way to implement Outcome Based Environmental Regulation (OBER).

The draft methodology talks of “combatting climate change” as one of the challenges facing the industry but then goes on to refer to it only a handful of times at the very highest level (e.g. “given the pressures of climate change…”).

It is not until the expenditure allowances (pg.94, Appendix 9) and performance commitments (pg.39, Appendix 6) for net zero greenhouse gas emissions that this challenge is referenced

again. We are disappointed that there has been no development since Ofwat's January 2022 position paper, which clarified Ofwat's "expectations that companies' plans align with national government net zero targets". We believe our industry is well poised to go further, faster than the average of the UK (as set out in the industry white paper[1]) and are surprised that this ambition is not reflected in the draft methodology.

It is critical that we are able to take approaches that both adapt to climate change and mitigate climate change. We talk further about the need to adopt innovative approaches and how these should be funded in our response to chapter 9.

The draft methodology also talks of "protecting and enhancing our environment" but goes on to suggest performance commitments that will drive perverse behaviours for the environment such as leakage, which will (as it has in PR19) require companies to emit more carbon and spend millions of pounds of customers' money – even though we are abstracting sustainably from the environment. The marginal cost of treating and distributing more water is significantly lower than that of reducing leakage and so the focus should be on sustainable abstraction, considered holistically alongside affordability and net-zero carbon, rather than a series of components that may or may not be an efficient (in terms of overall social, economic, and environmental costs and benefits) way to deliver that sustainable abstraction.

We are pleased to see the draft methodology supporting an advanced WINEP and strongly support a WINEP that sets outcome targets at catchment scale applied to all catchments in a company's area.

It also talks of "affordable bills" and yet continues to focus on average bills, rather than customers' ability to afford their bills.

The draft methodology (section 2.3.2) outlines that "Customers should not be asked to pay again for what should have already been done earlier". We support this, but would seek a clarification that, given changes over time, such as climate change and biodiversity net gain, might mean we have to re-think how current solutions and assets deliver our services and this may require additional expenditure. It is also critical that we consider the cost of resilience, particularly in the face of targets that might be set at zero failure.

We are concerned that the challenges do not include nutrient neutrality. This proposed new duty is forecast to drive our capital expenditure on just phosphorus and nitrate schemes to c.£1.35bn for PR24. This compares to a total, company-wide capital expenditure of c.£1.4bn at PR19. It is also critical to recognise the carbon impact of such a scheme; from our analysis, on average for every 1 tonne of phosphorus removed via a traditional grey asset solution (as required by the guidance) 4 tonnes of carbon dioxide are created.

We must have ambition to deliver environmental and customer improvements in the most efficient and economical way possible. Our Strategic Direction Statement sets out our vision for the next 25 years and, alongside the water sector white paper, demonstrates how OBER can ensure we do that. We hope to see more of this ambition reflected in the final determination.

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[1] https://www.water.org.uk/water2050/

2.2. Do you agree that continuing to use our three building blocks helps push companies to meet our ambitions for PR24? (Please provide detailed comments on specific building blocks to the relevant chapters.)

Disagree

Key messages

- The outcomes regime, cost assessment process, and risk and return framework could be an appropriate basis for effective regulation. However, these elements are underdeveloped and are unlikely to be effective in their current form.

Additional points

- Outcomes - review is needed because the draft methodology focuses on inputs and outputs that will not deliver the right outcomes as regards the development and maintenance of an efficient and economical system of water supply and sewerage services.
- Cost Assessment - the approach in appendix 9 falls short of what is needed for Ofwat to meet its own objectives and to act in accordance with the UK Government SDS.
- Risk and return - proposed changes are not in the long-term interests of customers and are likely to reduce the attractiveness of the sector to new investment and risks companies not being able to finance their functions.

The building blocks of the outcomes regime, the cost assessment process, and the risk and return framework are a sensible basis for effective regulation if they are applied appropriately. We are, however, concerned that there is a long way to go to ensure that this is the case.

Outcomes

We fully support the concept of outcomes. The rhetoric in the methodology is hugely positive.

“For the sector to succeed, it is vital that companies deliver the right outcomes for their customers, society and the environment. We do this through our outcomes framework, which holds water companies to account for the outcomes that customers pay for and incentivises them to go further where it will deliver value. It has also been supported by stakeholders' responses.

We are creating simpler and stronger incentives for outcomes through streamlining our approach. We are doing this by focusing on the key outcomes.”

Unfortunately, the methodology then goes on to focus on a range of inputs and outputs that will not deliver the right outcomes for customers, society, and the environment and will hinder rather than support the development and maintenance of an efficient and economical system of water supply and sewerage services. We discuss this further in our responses to section 5.

Cost assessment
The methodology shows awareness of some of the important limitations of the PR19 approach. Ofwat also highlights guidance from the UK Government SDS that is highly relevant to the need for the regulatory approach to be modified at PR24.

However, the approach set out in appendix 9 falls far short of what is needed if Ofwat is to meet its own objectives and act in accordance the UK Government SDS. Across appendix 9 we see a lack of ambition and innovation to actually tackle Ofwat's stated priorities and address customer needs.

We discuss this further in our responses to section 6.

Risk and return
Overall, the changes proposed in the finance sections of the draft methodology are not in the long-term interests of customers. The draft methodology is likely to reduce the attractiveness of the sector to new investment at precisely the time when significant investment is required to meet climate change and environmental challenges. This risks companies not being able to finance their functions.

We discuss this further in our responses to sections 7 and 8.

2.3 Do you agree that we have struck the right balance between what's in and what's outside of the price control?

Agree

Key messages
- We broadly agree with balance of the scope of price control.
- Please refer to questions 3.4 and 3.5 for our additional comments about how developer services should best be accounted for and how DPC is applied.

We broadly agree with the balance struck between what’s in and what’s outside of the price control. In particular, we have comments around how developer services should best be accounted for and how DPC is applied, both in section 3 (questions 3.4 and 3.5 respectively).

2.4 Do you have any comments on our approach to evaluating progress? What specific evaluation questions (based within the four key ambitions) do you think an evaluation should look to answer?

N/A – Neither agree nor disagree

Key messages

- We encourage Ofwat to consider all counterfactuals in its evaluation rather than relying solely on a comparison of PR24 and PR19.
- The key question in evaluating progress should be whether the outcomes for customers, society and the environment have been delivered in the most efficient and economical way.

We support this approach but encourage Ofwat to consider all counterfactuals in its evaluation, rather than just a comparison of PR24 to PR19. It should, for example, evaluate what could have been done in a full OBER scenario (on the assumption the final methodology doesn't adopt OBER).

The key question to be considered is whether we have delivered the outcomes for customers, society, and the environment in the most efficient way possible or whether the methodology restricts delivery options to those that are less efficient.

Chapter 3 - Design and implementation of price controls

3.1 Do you agree that in our final methodology we should commit to introducing either an adapted water trading incentive or a new water trading incentive at PR29? If you have a preferred approach, please provide reasons, including any thoughts on how the options we set out in Appendix 2 could be improved.

Agree

Key messages

- We agree that a long-term commitment to the water trading incentive is in the best interest of all stakeholders. Providing this certainty will enable companies to better commit to these, often long term, solutions ensuring that the most efficient solutions are taken overall.
- Overall, we favour option 1 - the evolution of the current approach. This gives long term certainty on the type of incentive, rather than risk creating any perverse incentives around the timing of new trades. We also support the proposal to move the incentive payments in period, as this will more closely align business decision making with its impact.
- Although we see some merits with option 2, we cannot see the benefit that the increased regulatory burden would have over option 1.

We agree that a long-term commitment to the water trading incentive is in the best interest of all stakeholders. Providing this certainty will enable companies to better commit to these, often long term, solutions ensuring that the most efficient solutions are taken overall. Overall, we would favour option 1 - the evolution of the current approach. This gives long term certainty on the type of incentive, rather than risk creating any perverse incentives around the timing of new trades. We also support the proposal to move the incentive payments in period, as this will more closely align business decision making with its impact.

Although we see some merits with option 2, we cannot see the benefit that the increased regulatory burden would have over option 1.

3.2 Do you agree with our proposals to:

a) **Continue to include network reinforcement in the network plus price controls?**
b) **Remove wastewater site-specific developer services from the wholesale wastewater network plus price control?**

Agree

Key messages

- Our preference is that both (a) and (b) should be excluded from the price controls. This will:
    - ensure that those responsible for triggering the investment pay their share;
    - provide end users with additional protection from any potential under recovery of revenue; and
    - provide companies a greater incentive to set cost reflective charges.
- However, retaining network reinforcement within the price control is currently a measured and practical approach. But only if cost allocation can be resolved, because network reinforcement is driven entirely by third parties, it could be excluded from the price control or at least assessed separately from the general wholesale controls.

In principle we think both these should be excluded from the price cap, as this will:

- ensure that those responsible for triggering the investment pay their share,
- provide end users with additional protection from any potential under recovery of revenue, and
- provide companies a greater incentive to set cost reflective charges.

However, we think retaining network reinforcement within the price control is currently a measured and practical approach. This is due to the close interaction network reinforcement expenditure may have with other enhancement drivers, such as flooding, and/or capital maintenance. This will create additional cost allocation risks that will likely not be consistent across the industry and so increase the risk of mis specifying totex allowances.

However, if cost allocation can be resolved then as network reinforcement is driven entirely by third parties, we think it should be excluded from the price control alongside other third party driven investment, or at least assessed separately to the general wholesale controls.

3.3 Do you agree that the inclusion of network reinforcement in cost sharing would be enough to manage uncertainty around the volume and mix of network reinforcement work to be delivered?

Agree

Key messages

- This question cannot be answered fully before Information about the final cost allowances is provided.
- In principle, we agree that that cost sharing is sufficient to manage the uncertainty around network reinforcement expenditure.
- Note that if a coarser approach to cost sharing is taken, provision may be needed for additional risk sharing (e.g. to include local factors).

In principle we agree that cost sharing is sufficient to manage the uncertainty around network reinforcement expenditure. However, without knowledge of what final cost allowances will be we cannot give full agreement.

When setting infrastructure charges, companies should be looking forward at the expected investment required over the next five years. This should take account of the expected ranges and as long as these forecasts are reflected in cost assessment then we think the balance of risk through totex sharing is appropriate.

However, if a coarser approach to cost assessment is taken, then there may be a need to include additional risk sharing, specifically as local factors often significantly drive network reinforcement that are not readily modellable at a company level.

Additionally, this requires cost sharing to be undertaken appropriately, with symmetric sharing rates that do not skew long term incentives.

3.4 For water site-specific developer services:

a) **Do you agree with our proposal to exclude new developments of more than 25 properties from the wholesale water network plus price control at PR24, but with transitional arrangements for companies with low levels of competition?**
b) **Do you think that new developments of 25 properties and fewer should remain in the wholesale water network plus control or be removed? If they were removed from the price control, what alternative protections could we introduce to protect new connection customers from monopoly power?**

a) **Agree**
b) **N/A**

Key messages

- We agree with (a) and believe that for (b) that new developments of 25 properties and fewer should also be removed in the price control. We expand on this in our longer answer.
- Moving these activities outside the price control doesn't prevent Ofwat from setting charging rules and retaining dispute power. Charging rules should require companies to set competitive and cost reflective charges on a level playing field with self lay providers. This should provide the protection needed and would not require transition arrangements.
- A critical backstop protection for users can be provided through the continuation and evolution of the current charging rules for new connection services.

Additional points

- Leaving plots with 25 or fewer properties in the price control will cause challenges e.g. in relation to accounting, administration and logistics, duplication and inefficiency of services, and the creation of perverse incentives for developers to split plots.
- Moving these developments outside price control provides the potential for better service including options to scale inspection and adoption resources and increase flexibility.
- We are opposed to the use of any coarse measure, such as price increases linked to CPIH because this will quickly lead to charges that do not reflect cost. Maintaining charges that are cost reflective is critical.
- We want to flag that strong inspection and adoption powers must be retained in order to create and adopt assets of appropriate quality and service life into the public asset base and that the accreditation market is not yet mature and we continue to work closely with 3rd party service providers to promote high delivery standards.

Following our principles set out in response to question 3.2 we think that investment and revenue from both small, and large developments should be excluded from the price control.

We understand Ofwat's concern that the market is not consistently developed across the country and therefore customers could receive varying levels of service, and be insufficiently protected, in some areas. However, we believe the market is rapidly developing and by the start of 2025 we imagine it will be vastly different and less inconsistent than Ofwat fears.

We also believe that leaving plots with 25 or less properties in the price control will cause challenges, such as:

- perverse incentive for developers to split plots into groups of less than 25 properties, therefore not reflecting the true nature of their development

- Create accounting, administrative and logistical challenges (and potential reporting errors or differences between companies)
- Potentially creating some duplication of services and reducing efficiency, and therefore cost, to operate in both markets.

We agree that providing backstop protection for all users of our services is critical; customers still retain the choice of using the incumbent, or a self lay provider. However, we think this can be done through a continuation and evolution of the current charging rules for new connection services.

Moving these activities outside of the price control doesn't prohibit Ofwat setting charging rules and retaining dispute power for these services. These charging rules should require companies to set competitive and cost reflective charges, on a level playing field with self lay providers. This should provide the required protection and thus not necessitate any transition arrangements.

By moving these areas outside of the price control, there is also the potential to allow us to provide a better service for larger developers in particular; we may be able to, for example, easily scale inspection and adoption resources to better meet customer expectations and delivery timescales, services rather than being limited by the current revenue cap that can on occasion reduce our flexibility.

We would oppose any coarse measure, such as price increases linked to CPIH as this will quickly lead to not cost reflective charges, as there is little chance the basket of goods included within CPIH will match those activities undertaken in new connection services. It is critical that charges are cost reflective to ensure a level playing field with other market participants.

We would like to take the opportunity to flag that putting all these activities into the market does not guarantee the creation and subsequent adoption of assets of appropriate quality and anticipated service life; strong inspection and adoption powers need to be retained on Water companies to ensure well designed, good quality assets are offered for adoption into the public asset base. The accreditation market is not yet mature and we continue to work closely with 3rd party service providers, from concept, through design and installation to adoption, to promote high delivery standards. As a result it is common to go through multiple iterations of the site inspection/ rectification/re-inspection cycle before reaching an adoptable standard. We need to appropriately safeguard delivery of these long term assets with adequate adoption procedures to continue to provide a robust, reliable, low maintenance and cost effective network.

3.5 Do you agree with our proposals:

a) **To raise the size threshold above which companies should deliver schemes through DPC to around £200m lifetime totex?**

b) **For companies to deliver schemes through DPC by default above this threshold?**

Strongly disagree

Key messages

- The £200m threshold is the minimum at which DPC could be considered, but it should not be the default option as it may still not be in the customers' interest, particularly for smaller sized projects.
- There is insufficient information provided by Ofwat to support this specific threshold level.
- It is not possible to give a complete answer on the application of DPC at this stage, prior to the further guidance on DPC becoming available later this year.

Additional points

- We believe that the benefits through perceived efficiencies in design and build and in financing and operation are likely to be lower than currently thought.

Anecdotally, we understand that DPC is unlikely to be pursued until a level significantly higher than £200m and so we would suggest that the £200m threshold is a minimum at which DPC could be considered, but is not the default option as it may still not be in the customers' interest.

We agree that the existing threshold needed to be increased to ensure that the potential benefits identified by Ofwat would outweigh the additional burden of the DPC process. However, there is insufficient information provided by Ofwat to support the specific threshold level; it appears options beyond £200m lifetime totex were not considered. Reference is made to the 3 pathfinder projects currently in progress and that these have the potential of 6-40% net benefit over alternative arrangements. However, there is no detail about these projects. For example, it is not clear how close to the £200m proposed threshold these projects are. If they are close to this threshold and the information derived from the parties involved suggests the level of benefit highlighted, they would support the proposed threshold level. If these projects are substantially larger than £200m then they provide no evidence to support the proposed threshold.

We understand the desire to create competition where possible and therefore to set the threshold as low as possible to create the opportunity for competitive tendering. However, when each aspect is looked at, our understanding and knowledge suggest there would have to be very specific circumstances for the benefits identified to be realistic for projects of the value £200m or less that the default assumption suggests.

We believe benefits through perceived efficiencies in design and build are likely to be lower than currently thought. All companies deliver programmes through competitive tendering for design and build work, and often as combined packages. They are well skilled at driving commercial and delivery efficiency form the supply chain. Our recent experience for a possible design and build expression of interest on a treatment site highlighted the lack of desire to take on the risk associated with such projects on existing sites.

We are also uncertain over the benefits that could arise in financing; during the development of DPC, the investor community interest began at around the £500m lifetime totex level. Projects below this level are unlikely to create financing benefit over and above those which incumbents can already source.

We believe benefits through operation are also limited; our experience of being involved in operations and maintenance contracts is that unless an activity can be very clearly ring-fenced, the client pays for the risk and loses flexibility in decision-making. As a result most O&M contracts attempted in the sector have reverted to incumbent delivery as they have not been proven to be best value to customers.

Whilst we understand the benefits of creating market conditions, caution must be taken at low levels of project size i.e. £200 – 500m lifetime totex for DPC to be the default. We see no credible evidence in the draft methodology to support using DPC as the default and our experience suggests at these lower cost projects, it is not demonstrated that such programmes are best value for customers. Indeed, transcribing a process used on a multi-billion Thames Tideway programme to a £200m projects should require a lot more evidence to ensure customers are protected, compared to companies existing abilities to efficiently finance, procure and deliver.

We also note that the further guidance on DPC will not be available until later this year. Understanding changes to the technical guidance is key to giving a fully rounded answer on the application of DPC.

3.6 Do you have any views on any other aspect of our proposals in relation to:

- **a) The design of price controls**
- **b) Water resources**
- **c) Developer services**
- **d) Retail activities**
- **e) Bioresources**
- **f) Other controls**
- **g) The revenue forecasting incentive mechanism; or**
- **h) Direct procurement for customers?**

Neither agree nor disagree – N/A

Key messages

- Price control structure:
  - We do not fundamentally object to the single till price control structure proposed but questions the omission of its benefits through the review of PR14 [should this be PR19?] and this document.
- Key building blocks:
  - We fully support the continued use of the key building blocks outlined on page 25. Coupled with the long term guarantees such as the RCV and appropriate uncertainty / risk sharing mechanisms, these underpin the strong investor confidence in the sector. However, these mechanisms need to be correctly calibrated and should incentivise innovation and efficiency.
- Water resources:
  - We remain fully supportive of the continued use of regional solutions and thinks that ultimately the RAPID programme will deliver responses to these challenges in the most efficient way. In light of this we are supportive of removing the bilateral entry.
  - Our view is that the boundary of water resources and water networks plus should be revised and refer to our response to "PR24 and beyond" in July 2021.
- Developer services:
  - Our responses on the key issues proposed to developer services are set out at questions 3.2 to 3.4. We support removing this from the price control and does not see the need for a separate price control to govern it. However, there is value in the continued evolution of charging rules to provide protection for customers.
  - We support removal of the income offset because this will mean that developers pay the full network costs of the investment that they trigger.
  - − We think care needs to be taken on the inclusion of the NAV market.
- Water trading incentives:
  - Please see our response to question 3.1. We fully support the proposal to remove the requirement for utilisation risk sharing on large water resource investment.
- Retail Price Control:
  - We do not believe that it is appropriate not to have automatic indexation of revenues and there are no other retail sectors that take the inflation risk for five years as proposed. The current high inflation scenario highlights this risk.
  - If indexation is included, we remain broadly supportive of the five-year control and revenue reconciliation mechanism.
- Bioresource price control:

    - We are nervous about the proposed implementation because the removal of a long-term guarantee on fundamental regulatory building blocks such as the RCV proposes a material increase in risk for an asset intensive business. We will comment on this further when we submit our response for bioresources on the 16th September.
- RFI:
    - We are supportive of the RFI continuing and agrees with Ofwat's assessment of its benefits and technical proposals for implementation. With developer services moving out of the price control, we support also removing it from the RFI.
    - With more focus in third party revenue and costs, there are compelling arguments for excluding the revenue from the RFI.

Price control structure
Although we have no fundamental objection to the single till price control structure that you propose, we find the omission through the review of PR14 and in this document of its benefits odd. This represented a fundamental change at the time and we have not seen any analysis to support this continued structure.

Key building blocks
We are fully supportive of the continued use of the key building blocks outlined on page 25. These, coupled with long term guarantees such as the RCV and appropriate uncertainty / risk sharing mechanisms underpin the strong investor confidence in the sector. However, these uncertainty mechanisms need to be correctly calibrated. They should incentivise innovation and efficiency, otherwise we move to a world of overly complicated rate of return regulation.

Water resources
For water resources, we remain fully supportive of regional solutions. We think that ultimately the RAPID programme will deliver responses to these challenges in the most efficient way. In light of this we are supportive of removing the bilateral entry.

We discuss our thoughts on water trading incentives in response to question 3.1
We fully support your proposal to remove the requirement for utilisation risk sharing on large water resource investment due to the long term nature, and demand for resilience on these solutions.

As we discussed in our response to PR24 and beyond in July 2021 we think that the boundary of water resources and water network plus should be revised. Water resources and water treatment are intrinsically linked and so the current boundary does not lend itself to separate price controls.

However, we understand the rationale for retaining the current structure to provide regulatory certainty around the in-flight delivery of large water resource schemes.

We would also like to flag a comment around the utilisation risk on large water resource investments – page 29 of the main document. We would have expected, if a new check on asset utilisation based on normal operating conditions is being introduced, that those normal operating conditions are defined and how much headroom we are expected to have. We cannot find these in the draft methodology document and request clarity on this and whether

we would be penalised for building an asset that will have higher utilisation in the longer term for resilience but in the shorter term may have a lower utilisation rate.

Developer services

We discuss our thoughts on the key issues posed for developer services in response to questions 3.2 to 3.4. To summarise we are supportive of removing this from the price control and do not see the need for a separate price control to govern it. However, we can see value in continued evolution of charging rules to provide protection for customers.

We are also fully supportive of the removal of the income offset. A key principle in this determination should be “the polluter pays”. Removing the income offset will finally mean that developers pay the full network costs of the investment that they trigger. However, treatment costs will still be unfairly borne by the wider customer base, as highlighted by Frontier Economics in their April 2021 report for Ofwat.

With the growing NAV market, we think that some care needs to be taken in how this is reflected in how that revenue is recorded, ensuring it is consistent with how efficient expenditure allowances are set.

Retail activities

For the retail price control, we remain entirely unconvinced that no automatic indexation of revenues is appropriate. Ofwat presents no sufficiently substantial evidence in support of this proposal. We know of no other retail sector that takes the inflation risk for the five years as proposed. Whilst some contracts may take the risk for two years, most include annual indexation adjustments. The current high inflation scenario highlights this risk with almost all companies overspending on retail by c£325m or 20% (at an industry level) so far this price control period.

Otherwise, we remain broadly supportive of the five-year control (if indexation is included) and a revenue reconciliation mechanism.

Bioresources

For the bioresources price control, although we recognise and support the ambition here in fully addressing any residual opex/capex bias and promoting a price control more aligned with market forces, we are nervous of the proposed implementation. The removal of a long-term guarantee on fundamental regulatory building blocks such as the RCV, we believe, proposes a material increase in risk for an asset intensive business, where there are significant costs not related to volume risk. This poses a very real challenge. We will discuss our thoughts on this further in the specific bioresources response that we will submit by the 16 September. Regardless, we consider the draft methodology proposals materially increase the risk in this area.

The revenue forecasting incentive

We are supportive of the RFI continuing and agree with your assessment of its benefits and your technical proposals for its implementation (i.e. penalty thresholds & time value adjustments). With developer services moving out of the price control we would support also removing it from the RFI.

With more focus on third party revenue and costs, we can see compelling arguments for excluding the revenue from the RFI as associated totex is excluded from those sharing mechanisms. This will ensure that customers are protected as “the polluter pays”.

Chapter 4 - Reflecting an understanding of customers and communities

4.1 Do you agree with our approach to making sure that companies' price review submissions and our determinations reflect an understanding of customers', communities' and environmental concerns?

Disagree

Key messages

- We are supportive of the collaborative national research but have concerns about the way it is used and whether that will "make sure submissions and determinations reflect customers' concerns".
- There are contradictory statements in the draft methodology about how and when the research is to be used.
- We have significant concerns about affordability and the scale of the requirements being set out in policy and regulation. We are concerned that Ofwat's position on this is not strong enough and encourage Ofwat to engage more fully with respective government departments and quality regulators about the scale of these requirements, Ofwat's ambitions, and its obligations to deliver a plan that meets its statutory duties.

Additional points

- We are concerned that if the research must be used, some of the timelines are unworkable e.g. the estimated January publication of ODI rates.
- We question the appropriateness of the use of the research in some contexts because the peer review undertaken by eftec found the research to be unsuitable for use in Cost Benefit Analysis.
- We are concerned about the risk of relying on one piece of research for setting ODI rates because this research is based on a single point in time which may be skewed by circumstances at that time e.g. the cost of living crisis.
- We are concerned about the approach to local research and the weight and value it is given.

We very much agree that:

- business plans should reflect an understanding of customers' (current and future), communities' and stakeholders' concerns, needs and priorities
- support should be in place to support those who struggle to pay, and
- research and engagement should always be high quality, subject to independent challenge and robustly assured.

We have been very supportive of the collaborative national research but have several concerns over the use of it.

We note in 4.3.1 (table 4.1) that 'companies may choose to use customer valuations derived from the ODI rates research to inform business cases for delivery of outcomes for which cost enhancement proposals are developed'. Later in the document (appendix 9 page 32) it states we must use the research wherever possible. There are therefore contradictory messages and clarity is needed as to whether we have choice or must use the research.

If we must use it , the current timeline of estimated January 2023 publication of ODI rates is unworkable as we will have made significant progress on our investment appraisals by then and reworking all our assumptions will be challenging. We question whether this is appropriate in any case, particularly as the peer review undertaken by eftec found the research to be unsuitable for use in Cost Benefit Analysis.

We are also concerned about the reliance on one piece of research for setting ODI rates. A single point in time piece of research can be highly skewed by the environment under which it was conducted such as the cost-of-living crisis. As per our response to question 5.5 we believe Ofwat should draw upon other sources of research and apply triangulation to get a more representative view.

We are also concerned about the conflicting advice on the use of local research. We believe we should have the ability to influence our plan through our own local engagement with customers and communities.

For instance, in 4.3.1 (table 4.1) we note that Ofwat are relying on the small piece of qualitative research undertaken by CCW to inform customers' priorities. Companies have shared past and present priorities research conducted locally and we believe our own extensive and recent local research on customers' priorities should be used to inform our outcomes.

Also 4.3.2 states that Ofwat expects companies to conduct company-specific engagement to inform their proposals in a range of areas, including any bespoke PCs and related ODI rates. However, table 4.1 states that Ofwat expects companies to use the results of the ODI rates research, as far as possible, to inform any proposals for bespoke performance commitments and related ODIs.

It needs to be much clearer as to the value and weight Ofwat will place on local research. In 4.3.2 Ofwat state that they will make a judgment on the weight they assign to any company specific research in their triangulations – which may be zero. Again, our response to question 5.5 emphasises the need to triangulate across a range of research rather than a single piece. We are carrying out a variety of local projects to inform aspects of our plan, are meeting the minimum standards for engagement and following best practice guidance for triangulation so we expect the research to carry significant weight in decision making.

We are asked to set out our proposals if a single social tariff is not in place for 1 April 2025. It is unclear what engagement is required in this scenario and whether previous engagement while developing existing social tariffs is sufficient or companies are required to re-engage on individual tariff design and the acceptable level of cross subsidy.

There are significant concerns around affordability, given the scale of requirements being set out in policy and regulation. We are concerned that Ofwat is not taking a sufficiently strong position on this point and encourage them to engage more fully with respective government departments and quality regulators around the scale of these requirements and Ofwat's ambition and obligation to deliver a plan that meets all its statutory duties. It seems unlikely, therefore, that all that companies' price review submissions and Ofwat determinations will reflect an understanding of customers', communities' and environmental concerns.

4.2 Do you agree with our proposal to conduct open challenge sessions?

Strongly disagree

Key messages

- Our plan is being informed by a range of robust research projects that comply with best practice and high-quality research principles, stakeholder engagement and a variety of public consultation initiatives.
- There is already provision for robust and expert challenge through our Customer Challenge Group and the open challenge sessions we have planned across our region for next year, to which Ofwat will be invited.
- It is not clear that the additional open challenge sessions proposed by Ofwat will add value above that which will be gained through our planned approach.

Our plan is being informed by a range of robust research projects that comply with best practice and high-quality research principles, stakeholder engagement and a variety of public consultation initiatives.

Robust and expert challenge is in place through our Customer Challenge Group (which includes CCW) and its associated expert Vulnerability Advisory Panel and Catchment Panel.

For PR19 we held a number of face-to-face events across our region giving customers and stakeholders the opportunity to hear about and challenge our proposed business plan. We are planning to repeat these early next year and Ofwat will be invited to hear the views expressed first hand. We are therefore not convinced of the value that the two open challenge sessions proposed by Ofwat will add.

4.3 Do you have views on open challenge sessions can align with the collaborative approach in Wales?

We will not be commenting on this question.

4.4 Do you have views on how the outcome of collaborative customer research can contribute in the context of the collaborative approach in Wales?

We will not be commenting on this question.

Chapter 5 - Delivering outcomes for customers

5.1 Do you agree with our proposed package of common performance commitments? Is water demand best incentivised through separate performance commitments on household and domestic consumption and leakage or through a performance commitment measuring total demand?

Strongly disagree

Key messages

- We support the move towards a more streamlined, outcomes-based approach to setting performance commitments. This approach is partially aligned with our own Strategic Direction Statement.
- Ofwat's Draft Methodology is a step in the right direction, but it falls short of a full outcomes-based framework.
- We would like to take a more outcomes focused approach and could take the lead in this area at PR24.
- We support an approach to setting performance commitments at the level of total water demand (preferably a net approach, accounting for example, for water returned to the catchment through stream support mechanisms focusing on sustainable abstraction); we strongly disagree with leakage, PCC and business demand as individual performance commitments as they are all output focused measures.
- We disagree with a number of the proposals at a more detailed level as set out in the response below.

At a high-level, we support the move towards a more streamlined, outcomes-based approach to setting performance commitments (PCs), with these being focused on those outcomes that matter most to customers and the environment and that help to deliver service improvements over the long term.

We also support the approach to streamlining the choice of common PCs to focus only on those that are suitable for financial incentives. This is a sensible approach to ensure delivery of customer and environmental outcomes.

Such an approach is aligned with our own Strategic Direction Statement (SDS) and, in principle, should allow companies to decide which tools and service delivery options are best suited to their circumstances, while still being held accountable for the delivery of service outcomes that are expected of them. The figure below shows the extent to which the draft methodology proposals for PCs aligns with the approach we have set-out in our SDS.

Customers receiving excellent service everyday	Environmental outcomes
Water supply interruptions	Biodiversity
Water quality compliance (CRI)	Operational GHG emissions
Water quality contacts (taste, odour, and appearance)	Leakage
Internal sewer flooding	Per capita consumption (PCC)
External sewer flooding	Business demand
C-Mex	Water demand (leakage and consumption)
D-Mex	Total pollution incidents
BR-Mex	Serious pollution incidents
Asset health	Discharge permit compliance
Mains repairs	Bathing water quality
Unplanned outage	River water quality
Sewer collapses	Storm overflows

Key:

Aligns with SDS | *Partially aligns with SDS* | *Does not align with SDS*

While Ofwat's Draft Methodology is a step in the right direction, we still think that there are aspects of its proposals where there is room to move a great deal further towards a full outcomes-based framework. We would like to take a more outcomes focused approach and we could take a lead in this area at PR24 if not all companies are ready and willing to accept the higher levels of risk and potential reward that innovating to deliver against these outcomes would require.

As it stands, we disagree with a number of the proposals at a more detailed level. In particular, we note the following:

Discharge compliance and storm overflows

Ofwat's proposed measures are output rather than outcomes focused. The storm overflows measure also double counts with the proposed river water quality PC that Ofwat has proposed. We comment further on this in section 5.3 of our report provided alongside the chapter 6 questions. Measures of discharge compliance and storm overflows that are adopted should rather capture an outcome-focused measure related to the environmental impact and harm caused by spills. We suggest that the measures in our SDS reflect the key acute and chronic impacts on water quality (pollution incidents, phosphorus, and nitrates).

The draft methodology makes an inappropriate assertion about companies' ability to deliver reductions before 2025 that are unfunded and unplanned. This should be for individual companies to assess the options and make their own decisions on delivery for the remainder of this AMP.

Leakage, PCC and business demand

We support an approach to setting performance commitments at the level of total water demand (preferably a net approach, accounting for example, for water returned to the

catchment through stream support mechanisms focusing on sustainable abstraction). Leakage, PCC and business demand are all output-based options for delivering the outcome of sustainable abstraction. Setting three separate targets all aiming to achieve the same outcome is therefore likely to lead to inefficient outcomes, as it restricts companies' choice of using the most appropriate actions to deliver the outcomes that matter most for customers and the environment. This would be at odds with the SPS which states that companies must act to reduce demand for water in a way that represents value for money in the long-term.

In doing so, however, we also recognise that setting a single, outcomes-based measure for water demand / sustainable abstraction does need to account for any exogenous factors that might affect companies' actions and ability to deliver against this outcome, as this could lead to perverse penalties. We therefore propose that the aggregated water demand PC needs to be defined to exclude any water abstracted that is then directly used to support stream and/or river flows. These flows are routinely separately measured as part of existing abstraction licence conditions.

We recognise that some companies may be unwilling to embrace an outcome approach as fully as Wessex. We would therefore be happy to take a lead in this area for PR24, in advance of a potential wider adoption in PR29.

Asset health measures

All three of the proposed asset health measures (i.e. mains repairs, unplanned outages and sewer collapses) reflect inputs or outputs rather than outcomes. While we agree that it is critical for companies to report on these measures, they do not need to be incentivised through the outcomes framework. These outputs should be incentivised through other outcomes-based performance commitments, for example water supply interruptions, with their incentive rates covering the long-term benefits for customers through additional end of AMP RCV adjustments rather than simply the short-term benefit as currently proposed. This would set sufficiently powerful incentives to ensure companies maintain the health of the assets needed to deliver the customer-facing outcomes. This is an approach we would be prepared to adopt at PR24 outside of the standard approach.

Unplanned outage

We believe this is an output focused measure and should not be included as a common performance commitment. The ultimate impact on customers of no water is covered by the supply interruptions commitment, and so we do not believe there is a gap in the customer or environment areas that needs to be filled by this metric.

Bathing water quality

As noted in our previous consultation response to Ofwat's 'PR24 and beyond: Performance commitments for future price reviews' document, defining a PC for bathing water quality based on meeting a good/excellent status for designated bathing waters is not appropriate. Companies have limited control over bathing water quality, and in particular inland bathing

water quality, which is largely outside of companies control and they therefore have limited ability to deliver and drive improvements. We provided evidence of this in our previous consultation response through our experience at Burnham Jetty North and the associated bathing water PC, where after £31m of investment in our assets, the bathing waters remained below the required standard due to half the microbiological pollution emanating from livestock. Burnham Jetty North was eventually declassified as a bathing water. While we recognise that partnership working can and should be used as a key delivery method in delivering such outcomes where it is more efficient to do so, we cannot and should not be held accountable and incur penalties for third parties failing to deliver their share of an outcome. We therefore suggest that, if this measure is to be included as a common PC, that it be defined to focus only on coastal water quality. A measure for coastal water should be based on reductions in nutrient load which companies can control and work with partners to deliver rather than the ultimate designation of the water itself. This is reflected in our proposed outcome measures of pollution incidents, phosphorus, and nitrates.

Water quality customer contacts

This measure also represents an output rather than an outcomes-based PC and can, in our view, be removed. Customer satisfaction is measured through the C-Mex and BR-MeX outcome measures and the water quality outcome is measured through CRI; therefore removing water quality contacts would remove a double count.

There is also a particular risk that this output-based measures is overweighted in the setting of incentive rates, given that customers can often equate this measure with water safety in customer research and the methodology proposes to focus only on the collaborative research to inform the ODI values.

Moreover, this measure provides a perverse incentive for companies to provide poor customer experience. Wessex Water prides itself on having a human answering the phone after only a few rings. This proposed measure would, however, incentivise us to leave the phone ringing in the hope that customers give up and therefore don’t contact us about their water quality. We strongly advocate removal of such incentives.

5.2 Do you agree with our proposed guidance for bespoke performance commitments?

Agree

Key messages

- Provided that outcome-focused common PCs are retained, we support the move to setting fewer bespoke PCs to the extent that this is consistent with adopting an outcomes framework with bespoke measures that reflect outcomes that matter to customers and the environment.
- We are concerned that if outcome-focused common PCs are not retained, bespoke PCs could be used by companies to introduce appropriate incentives to support their ambitions.
- It is important that aspects of the bespoke measures are carefully balanced. This includes commonality of bespoke measures across companies and criteria for bespoke measures.

As with Ofwat's approach to common performance commitments, we support the move towards setting fewer bespoke PCs, to the extent that this is consistent with adopting an outcomes framework with bespoke measures that reflect outcomes that matter to customers and the environment.

However, in line with our response to question 5.1, this view is predicated on retaining more outcome-focused common PCs (such as river water quality and water demand). If not, bespoke PCs could be a mechanism through which ambitious companies seeking a more outcomes-based environmental approach can introduce appropriate incentives that calibrate the overall risk and reward balance appropriate to that ambition.

We also note the following aspects of the approach to bespoke measures that need to be carefully balanced:

Commonality of bespoke measures across companies

While we think it is important to limit bespoke measures to focus only on outcomes that are not captured as part of the common PCs, we note that restricting this to 2-3 bespoke measures per company while also seeking commonality across any bespoke measures put forward risks this approach becoming too streamlined, with differences between companies and their customers' priorities not being fully captured. While we agree that the use of standardised definitions for the bespoke measures proposed across companies will support better comparability, this needs to be balanced with ensuring the definitions put forward by companies appropriately capture local needs, and that a 'one-size-fits-all' approach is not adopted by default at the detriment to customer and environmental needs.

Criteria for bespoke measures

Companies should be able to use bespoke measures to capture outcome-based measures in the event that the methodology retains output-based measures as the common measures. Outside of this we agree that any additional bespoke measures chosen by companies

should reflect measures that capture local circumstances and/or poor service on a common issue. However, we note that this does risk bespoke PCs being applied that are more focused on the downside, i.e. areas where companies face a greater risk of underperforming. This therefore needs to be balanced with ensuring that each measure appropriately reflects customer priorities for each company.

5.3 Do you agree with our proposed approach to setting standard rates?

Disagree

Key messages

- Our view is that the proposed approach creates a disconnect between the cost and service link between ODI levels and delivery methods.
- We have identified several issues with the approach proposed by Ofwat.
  - We are concerned about removing marginal costs altogether.
  - Removing marginal costs from the formula means that there is a strong likelihood that customers will receive more than their valuation of each unit of service, or will pay more than their valuation for each unit of service.
  - The formula is dependent on the MB estimation and therefore requires robust inputs from high quality customer research and as it is intended to use the collaborative research as the primary input (without a process of explicit triangulation with the substantial body of customer research), this is a high risk approach to ODI calibration.

Additional points

- We support an approach that can simplify this complex area.
- In principle, we support the use of symmetrical incentive rates that are based on a simplified formula because this removes some of the complexity and provides a better balance of incentives.
- We support an increase in the incentive rates because it will manage the risk of out- and underperformance.
- So that Ofwat can achieve its ambition of setting a symmetrical approach, it is important that Ofwat considers the standard incentive rate approach not just on its own but in the context of the overall risk and reward package.

We believe that that the approach does create a disconnect between the cost and service link between ODI levels and delivery methods, but overall agree with the approach to simplify what can be a very complex area.

Ofwat's proposed approach to setting standard incentive rates leads to three key changes (for a given level of marginal benefit (MB)): 1. reward rates will be higher, 2. reward and penalty rates will be the same 3. At a 50% cost sharing rate, if marginal cost (MC) < 0.6* MB the incentive rates for penalties will be higher (if MC > 0.6*MB the penalty rate will be lower than at PR19). In principle, we support symmetrical incentive rates that are based on a simplified formula as this removes some of the complexity and provides a better balance of incentives. We also support an increase in the incentive rates as we accept the challenge to manage the risk of out- and underperformance. However, there are a number of issues with the detailed approach that Ofwat has proposed:

- We understand that it is difficult to obtain consistent, high quality marginal costs to populate the PR19 formula, but we are concerned with removing marginal costs altogether. This type of simplification ignores basic economic theory that would suggest that the appropriate level of penalty needs to reflect the proportion of potentially avoided marginal costs that are already returned to customers via the cost sharing mechanism.

Removing marginal costs from the formula means that this link is not acknowledged and we impose an untested and arbitrary assumption on the relationship between MBs and MCs (i.e. MB – MC * 50% = MB * 60% implies that MC = MB * 80%) . Otherwise the formula seems to suggest that costs are separate to ODIs. In other areas of the price control, Ofwat has tried to link costs and service more closely which is at odds with removing marginal costs from the ODI formula.

- Similarly, the PR19 formulae made sure that customers are fully compensated for service levels below the target and the penalty rate reflects their overall valuation of a unit of performance. Removing marginal costs from the formula now means that there is a strong likelihood that customers will receive more than their valuation of each unit of service, or end up paying more than their valuation for each unit of service.
- We note that the formula is very dependent on the MB estimation and therefore requires robust inputs from high quality customer research. We note that Ofwat is intending to use the collaborative research as its primary input without a process of explicit triangulation with the substantial body of customer research that companies have developed over the past decade. This is a high risk approach to ODI calibration. We have seen in previous price controls that a single piece of research at one point in time is not sufficient to inform such important price control decisions and it is much more preferable to rely on a body of research that can be triangulated. For more detail on this, see our response to Question 5.5.

It is important to not just consider the approach to standard incentive rates in isolation from the calibration of the risk and reward package. The formulae provide the “bottom-up” approach that will then need to be combined with the targets and probability distribution around achieving the target to the derive the relevant RoRE ranges. Ofwat has indicated that it is aiming for symmetry in the incentives. With the formulae suggesting that penalty and reward rates will be equal, symmetry can only be achieved by setting the target at the P50 level and ensuring that the P10 and P90 performance levels lead to similar levels of financial penalty and reward. Ofwat also needs to consider the impact of performance commitments that only have downside (such as CRI) as well as enhanced incentive rates. The latter may be achieved at a level beyond the P90 performance level so there may not affect symmetry in the way it is usually measured. Ofwat has also indicated an overall RoRE envelop that it aims for. With fewer performance commitments compared to PR19 but a similar target range, the formulae may not lead to sufficient high incentive rates unless the P10 and P90 performance level are wide. We therefore suggest that Ofwat considers the standard incentive rate approach not just on its own but in the context of the overall risk and reward package so that Ofwat can achieve its ambition of setting a symmetrical approach.

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

Agree

Key messages

- Much of the detail of the measure for BR-MeX is still to be determined and is therefore difficult to provide meaningful commentaries on without it. However, we have provided comments on ways it could be implemented such as more quantitative scoring measures alongside qualitative scoring
- We generally agree with Ofwat's proposed approach to the measure of performance commitments.
- C-MeX should remain a broad measure of customer experience. Service to customers in vulnerable circumstances or those considered worst-served is best incentivised through other means such as the proposed Customer Licence Condition.
- There is little information provided on BR-MeX, but we believe that it needs to have an objective element as well as a qualitative aspect.

Whilst we generally agree with Ofwat's proposed approach to the measures of experience performance commitments, including C-Mex, D-Mex and BR-Mex but note that a lot of the detailed approach to the measures is still to be determined and as a result have several areas we think need reviewing.

We have provided more detail in our responses on C-MeX and BR-MeX in question A6.1-3 for appendix 6.

In summary, for C-MeX:

- We believe the check and challenge process should be retained
- There may need to be a correction factor applied if more online surveys are completed for the Customer Experience Survey (CES)
- We would like early sight and discussion around the potential requirement for additional communication channels
- We would like postcodes, even if truncated, to be added to the CES survey output to allow the data to be used by companies in a meaningful way
- We are concerned about the proposed timing for finalising the design of C-MeX. We believe this should be published in the Final Methodology so companies can factor any implications into their business plans
- C-MeX should remain a broad measure of customer experience. Service to customers in vulnerable circumstances or those considered worst-served is best incentivised through other means such as the proposed Customer Licence Condition
- We believe the CES element of C-MeX should be removed; it is providing perverse incentives by driving companies to spend money on marketing and building awareness rather than fundamental improvements to service. This is reflected in the scores, where there are companies who perform well on CES but perform poorly on customer service. Unless improvements in CES can demonstrably lead to improvements in customer service scores, it is inappropriate to incentivise expenditure for no service improvement.

For BR-MeX:

- We have reservations as to the measures being suggested and whether they will provide a truly accurate assessment of that performance. They have the potential to be highly subjective
- We believe that, as per D-MeX, a more objective measure should be part of the definition, and propose that the Operational Performance Standards (OPS) table would provide a useful addition
- We believe there should be weighting in the scoring criteria for the retail element; a retailer with 90% of a wholesaler's SPIDs has the same scoring influence as a retailer with just 1% of the SPIDS
- Retailers need to be more engaged with the measure as neutral scores or non-completion are common
- The detail on the business customer element has not been confirmed, so we cannot comment in any detail. However, immediate concern is whether a customer can differentiate between the retail and wholesale functions when being surveyed, and indeed between supply and waste side providers for those who sit within a WOC supply area

For D-MeX we have no objections to the overall proposal, but would like to see the anonymity clause removed. Without knowing the specific customer, it is difficult to draw conclusions about the circumstances that lead to a poor result and take actions to resolve. It should align with the principles behind C-MeX, where customer incident details are provided in the CSS.

We are supportive of increasing the size of C-Mex as it provides an important measure of customer experience. Ofwat has not provided an indication of how much it might scale C-Mex and we would suggest that an increase from 12% of retail revenue to 20% may be appropriate. We agree that BR-Mex can be calibrated relative to C-Mex. We recommend calibrating against the scaled up version of C-Mex rather than the PR19 version to ensure consistency.

We believe the CES element of C-MeX should be removed; it is providing perverse incentives by driving companies to spend money on marketing and building awareness rather than fundamental improvements to service. This is reflected in the scores, where there are companies who perform well on CES but perform poorly on customer service. Unless improvements in CES can demonstrably lead to improvements in customer service scores, it is inappropriate to incentivise expenditure for no service improvement.

5.5 Do you agree with our proposed approach to estimating marginal benefits for common and bespoke performance commitments?

Strongly disagree

Key messages

- It is not appropriate to use a single research project (the collaborative research) for the most common ODIs because there is a risk with this approach that the developed ODIs may not be defensible against stakeholder scrutiny.
- The previous two price controls have taught us that a full understanding of customer preferences comes from a body of research that uses a mix of high quality methods.
- Ofwat needs to include a process of triangulating the results of the collaborative research with the body of evidence developed by companies. This would ensure that there is full transparency and that appropriate checks and balances are in place without over-emphasising a single piece of research.
- Our view is that for bespoke measures, we should be encouraged to use the full wealth of customer engagement and opinions at our disposal and using a comprehensive set of valuations from multiple sources and methodologies correctly triangulated can help mitigate weaknesses.

Additional points

- The timing of the research and business planning means that companies will have to develop their business plans and their investment optimisation processes based on their own customer valuations because the results of the collaborative research will not be available at that time. As a result, plans will be optimised against one set of data while the incentives for delivery within the AMP will be calibrated based on another. This disconnect could be remedied through the use of triangulation.
- On greenhouse gas emissions and biodiversity, we suggest looking at market-based values where these are available as they are more likely to represent the true valuation of improvements than publicly available societal values.

Ofwat has proposed to use collaborative research for all marginal benefits (MB), except for GHG emissions and biodiversity where it suggests using values from public sources.

While the collaborative research adds value to the evidence base on customer valuation for PR24, using a single research project for most of the common ODIs is not appropriate. This approach ignores the body of customer research that companies have developed over the last decade and risks leading to ODIs that are not defensible against stakeholder scrutiny. There are many different high quality methods that can be used to understand customers' valuation of different service aspects that have different pros and cons but are not necessarily right or wrong. Over the past two price controls we have learned that a full understanding of customer preferences comes from a body of research that uses a mix of different high quality methods. Asking different questions about the same service aspects in different contexts provides a rich and detailed picture of customers' valuations. Ofwat's proposals therefore represent a step backwards. We suggest that Ofwat needs to include a process of triangulating the results of the collaborative research with the body of evidence developed by companies. We understand that this makes the process more onerous but in our view this is justified as it will lead to more defensible ODI rates. A triangulation process

would ensure that there is full transparency and appropriate checks and balances in place without overemphasising a single piece of research.

We also note that the timing of the research and business planning means that companies will have to develop their business plans, specifically their investment optimisation processes, based on their own customer valuations as the results of the collaborative research will not be available at this point in time. This means that plans will be optimised against one set of customer valuations while the incentives for delivery within the AMP will be calibrated based on the collaborative research. This disconnect means that there will be inconsistencies in how customer valuations are reflected. Our suggested process for triangulation would remedy some of this inconsistency and create a stronger evidence base for ODIs.

On greenhouse gas emissions and biodiversity we suggest looking at market-based values where they are available and robust, as these are more likely to represent the true valuation of improvements than publicly available societal values that are based on surveys (that are often outdated or not directly relevant to the geographies they need to be applied to). Appropriate cross-checks are needed, as mixing customer valuations from collaborative research with societal valuations can create anomalies and unintended consequences. We also consider market-based values appropriate for use in the cost assessment of net zero investments to determine the efficiency of different schemes.

For bespoke measures we should be encouraged to use the full wealth of customer engagement and opinions at our disposal. All engagement will have strengths and weaknesses and using a comprehensive set of valuations from multiple sources and methodologies correctly triangulated can help mitigate those weaknesses.

Furthermore, without re-running the Ofwat engagement with bespoke measures in to calculate the relative rank we think it will be very challenging to undertake research on exactly the same basis, we would have to impose additional assumptions (i.e. testing an issues importance relative to one of the pivot measures used in the Ofwat survey). This requires us to impose additional assumptions on the results, and seems in no way superior to a well triangulated figure as described above.

5.6 Do you agree with our proposed approach to incentivising asset health performance?

Strongly disagree

Key messages

- We do not agree with including asset health measures as ODIs as they are not outcomes. Please also refer to our response to question 5.1.
- We agree that asset health should be measured but the PCs should be customer-focused outcomes only.
- Our view is that the way to address the long-term impact of asset health deterioration is to create more certainty over the long-term incentives instead of measuring an output that is not customer-facing. A long term approach can be achieved by including penalties as RCV adjustments. See question 5.14 for more detail.
- If Ofwat persists with incentivising outputs, we suggest that a top-down approach is used as this is pragmatic and can be calibrated against other ODIs.

Additional points

- If asset health is included in ODIs, an inferred benefits approach is unlikely to work in practice as it will require too many arbitrary assumptions and will lead to double counting because the impacts are already captured by other PCs and ODIs.

As reflected in our response to question 5.1, we do not agree with including asset health measures as ODIs as they are not outcomes.

Ofwat has suggested using an "inferred marginal benefits" approach to develop the ODIs on asset health by allocating valuations of relevant customer-facing incidents to the metrics measured by asset-health. By having to use an inferred benefit approach, Ofwat effectively acknowledges that the real impact of asset health is assessed in other measures (such as supply interruptions) and asset health measures themselves do not represent meaningful customer outcomes.

While we do not disagree with measuring asset health, in our view PCs should be customer-focused outcomes only. We understand that Ofwat may be worried about the long-term impact of asset health deterioration, but this signals that there is an issue with the long-term incentives in the PR24 methodology and the way to address this is to create more certainty over the long-term incentives instead of measuring an output that is not customer-facing. A long-term approach can be achieved by including penalties as RCV adjustments (see question 5.14 for more detail).

If asset health measures are included, an inferred benefits approach may sound sensible, but we and other companies have tried this approach in previous price controls and in practice it does not work. This is because it requires a high number of assumptions around the impact of each mains burst or sewer collapse, including the ultimate customer impact (which can range from no impact to interruptions or sewer flooding), the number of customers affected, etc. In the past we have concluded that even with detailed engineering understanding, the inferred benefit values are not sensible as they:

1. require too many arbitrary assumptions (the results are very sensitive to the assumptions) and
2. lead to double counting, as the impacts that are valued are already captured by other PCs and ODIs.

As a result, should Ofwat decide to persist with incentivising outputs, we suggest using a top-down approach as a pragmatic approach that can be calibrated against other ODIs.

5.7 Do you agree with our proposal to retain, expand and streamline enhanced incentives?

Agree

Key messages

- In principle, we support the continued use of enhanced incentives if these are applied appropriately to provide companies with incentives to innovate and drive service improvements to customers and the environment.
- The most important issue is the implementation of enhanced incentives and the overall impact on the risk and reward balance. There is currently a lack of clarity on the implementation of enhanced incentives.
- We support the adoption of an expanded and streamlined approach to setting enhanced incentives for PR24.

Additional points

- To achieve their stated aim, the target levels for enhanced incentives need to be stretching but they must also be consistently achievable by companies.
- Enhanced incentives may assist Ofwat in making the ODI incentives symmetrical in PR24.
- The efficacy of the application of enhanced incentives is dependent on what aggregate thresholds are applied and these need to be set at a level that provides the right balance of achievable levels for companies and the additional cost burden to customers.

The most important question is about the implementation of enhanced incentives and the overall impact on the risk and reward balance. In principle, we support the continued use (although there is a lack of clarity on implementation) of enhanced incentives if applied appropriately. These should provide companies with the incentives to innovate and drive service improvements to customers and the environment. We also support the adoption of an expanded and streamlined approach to setting enhanced incentives for PR24. This will make the incentives framework less complex while providing all companies enhanced incentives to innovate.

To achieve their stated aim, the target levels for enhanced incentives clearly need to be stretching, but they must also be considered achievable on a consistent basis by companies, that is, within the companies control rather than relying on the chance of good weather. Identifying a single exceptional historical performance point (or a single future forecast) and then extrapolating a future threshold from that risks setting the threshold at a level where companies will need significant good fortune to achieve enhanced incentives. Companies have to allocate their scarce resources between competing projects during an AMP period and projects where the benefits are dependent on good fortune are unlikely to score highly, and this will ultimately dampen the incentive to innovate at the frontier.

Enhanced incentives may assist Ofwat in making the ODI incentives symmetrical in PR24. Again, for the ODIs set by Ofwat and the price control overall to be symmetrical in RORE terms, the enhanced ODIs need to be set in a way that is credible for companies to achieve

on a consistent basis, given that according to the methodology some ODI measures will be penalty only. We recommend that Ofwat considers whether a particular threshold is credible for companies to plan to be able to achieve consistently or whether it was achieved historically only by some exceptional and fortunate circumstance – for instance exceptionally dry weather. Significant further clarity is required here.

Furthermore, the efficacy of the application of enhanced incentives is dependent on what aggregate thresholds are applied. These thresholds need to be set at a level that provides the right balance between providing companies with realistic levels that they are reasonably able to achieve, while keeping in mind the additional cost burden on customers.

5.8 Do you agree with our proposed approach to selecting performance commitments for enhanced incentives?

Disagree

Key messages

- The criteria used to select performance commitments for enhanced incentives can go further, which is important to provide incentives for truly stretching performance. We suggest widening the number of commitments by doing the following:
  - adjust the principles set out in the draft methodology to better reflect and allow for environmental and community benefits (as well as for customers);
  - extend the application of enhanced to apply to river water quality in addition to the four measures that Ofwat has set out; and
  - If a common PC is set on an outcomes basis for total water demand, this should also have enhanced incentives applied. However, this should not be applied to separate output-based PCs for leakage and PCC.

We believe that the criteria Ofwat uses to select performance commitments for enhanced incentives can go further, and suggest widening the number of commitments that are included in the following ways:

- The principles set out in the Draft Methodology should be adjusted to better reflect and allow for environmental and community benefits (as well as for customers).
- Enhanced incentives should apply to all outcome-focused PCs where the measurement is well understood. We therefore think these should be extended to apply to river water quality, alongside the four measures that Ofwat has set out (i.e. water supply interruptions, internal sewer flooding, external sewer flooding and total pollution incidents). While river water quality does not have a history as a common PC, this measure is well understood by companies and enhanced incentives in this area will help to drive the environmental outcomes that are needed (consistent with our proposed amendment to the principles set out above).
- If a common PC is set on an outcomes basis for total water demand, then this should also have enhanced incentives applied. This is an area that is well understood by the sector, and enhanced incentives on this outcome-focused measure will therefore incentivise companies to deliver further improvements in delivering sustainable abstraction. However, in line with our response to question 5.1 as part of this consultation, enhanced incentives would be less effective if applied on separate output-based PCs for leakage and PCC and we would therefore not support applying enhanced incentives on this basis.

5.9 Do you agree with our proposed approach to setting enhanced thresholds, rates and caps?

Disagree

Key messages

- There is a need to ensure that the thresholds for enhanced incentives are set at a consistent level and at these are set at the correct level in order to be effective and to balance the levels that companies are required to achieve and the additional cost burden on customers.
- Our view is that the enhanced rewards should not be used to balance out the RORE ranges for the PCs that only have a penalty attached to them.
- It is not possible at this stage to give a view on the simplified approach to setting rates that Ofwat has proposed and more clarity is required from Ofwat.
- Caps should not be necessary if outcome-based measures are focused on the things that matter to customers, communities and the environment, where these are well-defined and where the delivery of the outcomes is within the companies' control.

We do not fundamentally disagree with elements of the approach, but as commented in 5.8 we need to ensure the thresholds for enhanced incentives are set at a consistent level. We also believe that the enhanced rewards should not be used to balance out the RORE ranges for the PCs that only have a penalty attached to them.

As noted in our response to Question 5.7, the efficacy of the application of enhanced incentives is dependent on what thresholds are applied. These thresholds need to be set at a level that provides the right balance between providing companies with realistic levels that companies are reasonably able to achieve, while keeping in mind any additional cost burden on customers.

We also do not fundamentally disagree with the simplified approach to setting rates that Ofwat has proposed, i.e. to reflect double the standard incentive rates. However, it is not possible to take a view on whether this simplified approach would provide more credible incentives for companies relative to the benchmarking externality approach adopted at PR19. Equally, it is not clear at this stage to determine whether either of the company-specific or weighted average approaches that Ofwat has outlined for the simplified approach would be more credible. As Ofwat has identified this depends on the difference between the standard incentive rates. It also depends on where Ofwat sets the threshold for enhanced incentives. A higher threshold would be aligned with higher rewards as achieving the reward is likely to require more cost and deliver more benefit to customers. The ultimate choice needs to be informed by the differences in standard incentive rates and the thresholds. Care needs to be taken when using these potential enhanced incentives in the RoRE analysis. If they are set beyond the current or forecast frontier, it is highly likely that in any reasonable scenario they will fall outside of the P10 position. It would be a fundamental mistake to arbitrarily impose an overall symmetric RoRE range relying on these incentives’

inclusion. We discuss more of our thoughts on the use of notional risk ranges in response to question 7.1.

As noted in our responses to this consultation on standard incentives rates, caps should not be necessary if outcome-based measures are focused on the things that matter to customers, communities and the environment, where these are well-defined and where the delivery of these outcomes is sufficiently in control of companies. Therefore, to the extent that the measures on which enhanced incentives are placed are outcomes-focused, we support Ofwat's proposal to remove caps on enhanced incentive measures.

5.10 Do you agree with our proposed approach to knowledge sharing?

Agree

Key messages

- We agree with Ofwat's proposal that companies that achieve enhanced performance will be required to share the knowledge behind their success with the sector.

Yes, we agree with Ofwat’s proposal that companies that achieve enhanced performance will be required to share the knowledge behind their success with the sector.

5.11 Do you agree with our proposal to set caps and collars on a targeted basis, and apply a two-sided aggregate sharing mechanism to all companies?

Disagree

Key messages

- We do not support the application of caps and collars because:
  - caps and collars will blunt incentives rather than protect customers;
  - targets such as bathing water quality must be set taking into account the company's ability to control the outcome but the draft methodology proposals to not achieve this; and
  - some PCs already have well-established measures.
- We do not agree that caps and collars are only needed if there are inadequacies in other aspects of the ODI framework.
- caps, collars and aggregated sharing mechanisms should not be necessary if:
  - outcome-based measures are focused on things that matter to customers, communities and the environment;
  - they are well defined; and
  - where the delivery of these outcomes is sufficiently in the control of companies.

Additional points

- Setting a symmetrical aggregate RORE sharing mechanism is a pragmatic way to recognise that companies are not able to manage all risks around PC performance - we support this as a general approach.
- Ofwat could consider a wider threshold before risk is shared with customers and could consider putting more risk on companies on both the upside and downside and in all cases, the final threshold needs to be consistent with the overall balance of risk and reward in the determination.
- The approach to risk needs to be accompanied by a more pragmatic approach to updating PC definitions within the AMP where this is in the customers' interests.

We believe that caps and collars only need to exist due to inadequacies in other aspects of the ODI framework, and we are therefore against the use of caps and collars.

Caps, collars and aggregated sharing mechanisms should not be necessary if outcome-based measures are focused on the things that matter to customers, communities and the environment, are defined well and where the delivery of these outcomes is sufficiently in control of companies.

Recognising that perfection in measures is unlikely to be achievable in practice, setting a symmetrical aggregate RORE sharing mechanism is a pragmatic way to recognise that companies are not able to manage all risks around PC performance. We therefore support this as a general approach. Ofwat could consider a wider threshold before risk is shared with customers.. It could also consider putting more risk on companies on both the upside and downside. And, in all cases the final threshold needs to be consistent with the overall balance of the risk and reward package in the determination.
We do not however support the application of caps and collars for the following reasons:

- Companies will have a small number of bespoke outcome measures defined only where these are sufficiently important to customers, communities and the environment, so in our view caps and collars will blunt incentives rather than protect customers.
- If benefits from outperformance are uncertain in a measure or it is difficult to set an appropriate target, these are strong signals that this should not be a PC. The asset health measures fall into this category for reasons outlined elsewhere in this response. Similarly, bathing water quality where we consider the target must be set taking into account the company's ability to control the outcome but the draft methodology proposals explicitly and deliberately do not achieve this.
- We note that some new PCs have established measures even though they may be newly incorporated into Ofwat's framework, in particular some of the new environmental PCs proposed do have well-established measures.

The approach to risk needs to be accompanied with a more pragmatic approach to updating PC definitions within the AMP where this is in customers' interests. We do not support the proposal not to intervene in customer's interests in future by amending PC definitions. We note that if this policy had been in place during this AMP, we would have had to build an entirely unnecessary shaft (meaning we and our customers incurred not only the cost of this, but also the carbon and construction impact through additional road closures) on our Trym tunnel to avoid what could have in theory been an unlimited, or at the very least large, penalty. Ultimately the costs of this would then have been borne both by customers and the environment. This seems to be too high a cost to bear in return for a short-term streamlining of regulatory processes.

5.12 Do you agree with our proposal to not set deadbands on any performance commitment?

Agree

Key messages

- We support the removal of deadbands if targets are set appropriately e.g. per our comments on setting caps and collars in response to question 5.11.
- 100% compliance is not an appropriate PC target given the current evidence. We recommend that Ofwat more rigorously assesses the point at which outcomes remain achievable and equitable before setting the target on compliance measures for PR24.

Additional points

- Under the draft methodology, there is a high probability that every company will be perceived to have been "fined" through receiving an ODI penalty. This creates a reputational risk for companies and regulators.
- Left unchanged, the draft methodology proposals would skew company ODI risks to the downside. The final methodology must explain how the ODI proposals achieve symmetry in the ODI risk overall.

If targets themselves were set appropriately (as per our comments on setting caps and collars in 5.11) – in particular, for those PCs with targets proposed at 0% or 100% - we would support the removal of deadbands.

We do not think 100% compliance is an appropriate PC target given current evidence. For CRI, we note that the Chief Inspector's 2021 report stated that Ofwat's *"CRI target of two has been set as the point at which financial penalties apply ensuring outcomes remain achievable and equitable when used as a water quality objective".*[2] We recommend that Ofwat more rigorously assesses the point at which outcomes remain achievable and equitable before setting the target on these compliance measures for PR24.

However, if these targets are not set correctly then we think there is a strong case for retaining deadbands for CRI and discharge consents, albeit we understand that, based on evidence, these deadbands could be adjusted over different AMPs.

The draft methodology proposals create reputational risk for both companies and regulators with a high probability that every company will be perceived to have been "fined" (receive an ODI penalty) for water quality with a target of 0 and no deadband. This will cause real detriment to customers if the ensuing publicity causes an unfounded loss of faith in the quality of the public water supply. The final methodology proposals need to consider whether this context of perceived constant failure would be helpful in the light of ongoing public conversations around lead and PFAS. Our view is that it would not be.

Left unchanged the draft methodology proposals here would skew company ODI risks to the downside. It will be important for the final methodology to explain how in total the ODI proposals achieve symmetry in the ODI risk overall. This is likely to require positively skewed incentives elsewhere in the ODI package that are credibly achievable.

[2] Chief Inspector's Report 2021, DWI https://cdn.dwi.gov.uk/wp-content/uploads/2022/07/12142457/Drinking-Water-2021-England-Public-Supplies-PDF.pdf

5.13 Do you agree with our proposed approach to estimating ODI risk?

Strongly disagree

Key messages

- The proposed methodology will not provide a true assessment of risk at the company level.
- The proposed methodology is likely to treat future risks in the same way as past risks although future risks (such as climate change) are changing and does not take account of correlations between risks.
- It is important that Ofwat considers risk in the round rather than in isolation. This is particularly because the direction of travel in PR24 seems to be that companies will bear more risk before this is shared with customers.
- It is very important that companies undertake their own risk analysis in addition to Ofwat's analysis and that the final methodology explains how Ofwat will engage with and take account of a well-evidenced company risk analysis in making its decisions on business plan incentives.

Additional points

- The draft methodology is not clear about Ofwat's requirements for a good quality and ambitious plan e.g. whether this means a wider range of risk and reward, use of Ofwat assumptions or simply applying the appropriate incentive rates. This needs to be set out clearly in the methodology to assist companies to develop high-quality plans that meet Ofwat's requirements.
- We are concerned about the limited opportunities within the methodology to engage on ODI risk in advance of Ofwat's Draft Determinations.
- The removal of the IAP stage places additional risk on companies because it reduces the ability to respond to challenges arising from uncertain PCLs. The reduced "check-in" points increases the risk that the final allowances and PCLs will be misaligned.
- In order for Ofwat to achieve its ambition of setting a symmetrical approach and because many aspects are interrelated, standard incentive rates must be considered alongside the calibration of the risk and reward package and not in isolation.

We think that the methodology outlined will not give a true assessment of risk at a company level.

It seems like it is likely to treat future risks as the same as the past, despite increasing challenges from climate change and other exogenous pressures. It may also fail to recognise that the probability of frontier companies continuing to improve performance may be lower than poorer performers. It is unlikely to take into account correlations between individual risks.

We further note that the direction of travel in PR24 appears to be that companies will need to bear more risk before this is shared with customers. It is therefore important that Ofwat considers ODI risk in the round rather than in isolation.

We therefore agree (and think that it is very important) that companies should undertake their own risk analysis on top of Ofwat's more streamlined analysis. It is important that in addition to reaffirming this option, that the final methodology explains how Ofwat will engage with and take account of a well-evidenced company risk analysis in advance of its decisions around business plan incentives. The draft methodology is currently silent on this.

It is also not clear to us what Ofwat considers good quality and ambitious in this context. If a company proposes a wider range of risk and reward in its plan, is this evidence of higher ambition? Or would it not meet "minimum requirements" because it doesn't "use Ofwat assumptions"? Or is it sufficient to mechanistically apply the appropriate incentive rates and to offer up an acceptable level of performance shift in its PCLs? Making this clear in the final methodology will assist companies in developing high-quality plans that meet Ofwat's requirements.

Our concern at the moment is that there are limited opportunities within the methodology to engage on ODI risk in advance of Ofwat's Draft Determinations. Companies can evidence their own risks based on their own proposed PCLs and the published incentive rates, but they will not be able to engage with any Ofwat interventions on PCLs until after the Draft Determinations. This will mitigate against companies seeking to develop and explain good plans that are right for their local context, the wider constraints in which they operate, current performance levels and the priorities of their stakeholders. Ofwat is more likely to receive homogenous plans that avoid risking failing Ofwat's quality tests and the penalties which apply. We have outlined our desire to take a more outcomes-based approach in our plan than perhaps is envisaged by this draft methodology, but we would expect this would need to be explained in the context of the additional risks being borne and the potential additional rewards available.

With the removal of the IAP stage there is additional risk placed on companies, as it reduces the ability to respond to challenges arising from uncertain PCLs. Some of these may require fundamentally different levels of totex to achieve, and the reduced "check-in" points increases the risk that the final allowances and PCLs will be misaligned.

It is important to not just consider the approach to standard incentive rates in isolation from the calibration of the risk and reward package. The formulae provide the "bottom-up" approach that will then need to be combined with the targets and probability distribution around achieving the target to the derive the relevant RoRE ranges. Ofwat has indicated that it is aiming for symmetry in the incentives. With the formulae suggesting that penalty and reward rates will be equal, symmetry can only be achieved by setting the target at the P50 level and ensuring that the P10 and P90 performance levels lead to similar levels of financial penalty and reward (note that this cannot be done with the enhanced incentives as we discuss above). Ofwat also needs to consider the impact of performance commitments that only have downside (such as CRI) as well as enhanced incentive rates. The latter may be achieved at a level beyond the P90 performance level so there may not affect symmetry

in the way it is usually measured. Ofwat has also indicated an overall RoRE envelop that it aims for. With fewer performance commitments compared to PR19 but a similar target range, the formulae may not lead to sufficient high incentive rates unless the P10 and P90 performance level are wide. We therefore suggest that Ofwat considers the standard incentive rate approach not just on its own but in the context of the overall risk and reward package so that Ofwat can achieve its ambition of setting a symmetrical approach.

If there is a continued tightening of the efficiency challenge on costs alongside increasing requirements (discussed in response to chapter 6) this reduces the companies adaptability and flexibility in responding to immediate PC pressures, increasing the overall risk borne.

5.14 Are there instances where providing greater clarity over our intended approach to incentive rates in PR29 would clearly be in the interests of customers? Please explain why and provide supporting evidence.

Neither agree nor disagree – N/A

Key messages

- The current approach is not sufficient because the treatment of and any advantage of outperformance is not clear, especially for innovative solutions and companies therefore have some delivery risk.
- If an opex solution is used, base costs would be higher but it is not clear whether this would be offset by the penalty avoided.
- A lack of long-term certainty impedes innovative solutions that would drive service quality forward. It is in customers' interests to fix the incentive imbalance so that companies can invest with greater certainty.

Additional points

- Our view is that RCV ODI adjustments could be considered further as these can be calibrated to give short term revenue impact and also give long term certainty.
- Committing to ODI payments for longer time periods can also reduce certainty and Ofwat should consider this because it has a significant impact on the long-term focus of companies' performance.

We understand the trade-off between incentivising efficient long-run investment and retaining sufficient flexibility in the short-run. We also recognise that signalling the continuation of the PC/ODI framework is a step towards longer-term incentives.

However, the current approach is not sufficient as it can lead to the following situations:

- A company that is faced with an investment decision to deliver ODI outperformance using capex only receives a share of the annualised customer benefit as part of the ODI reward. This means the company realistically receives 2-5 years of rewards (as it will take at least some time to deliver the scheme). At the next price control, the company can have an expectation that its improved performance may lead to avoided automatic penalties, a clear benefit to the company. However, it is also faced with higher costs that may be deemed as inefficient in the cost assessment. The company would therefore need to rely on the costs and the performance being reflected appropriately in the next price control so it is not worse off if delivering the investment. Companies currently have no certainty or clarity on how the framework for the subsequent price controls that cover the asset life of the investment will evolve. The investment proposition is therefore risky as only 2-5 years of pay-off are certain. It is therefore not clear that outperformance is worthwhile, particularly if solutions are innovative and therefore have some delivery risk.
- If the solution is an opex solution, base costs would be higher and it is not clear that this is offset by the avoided penalty.
- The impact on customers is that the lack of long-term certainty impedes innovative solutions that drive the service quality frontier forward. It is clearly in the interest of

customers to fix this incentive imbalance so that companies can invest in pushing the service quality frontier with greater certainty.

We think that ruling out the use of RCV ODI adjustments could face further consideration. The RCV is a regulatory construct that can guarantee long term impacts on value. Although it is an additional complexity we think that there is a case that RCV incentives provide a much longer term impact than the current revenue ones. They can be calibrated to give the same short term revenue impact (i.e. RCV adj = Incentive rate / (WACC + Run off rate) but also to give longer term certainty.

There are a number of ways of solving this including. Committing to ODI payments for a longer-time period is another way to reduce uncertainty. In our view, Ofwat needs to take this issue more seriously as it has a significant impact on the long-term focus of companies performance.

5.15 Do you have any comments on our proposed approach to implementing and streamlining payments at PR24?

Neither agree nor disagree – N/A

Key messages

- We support the use of continued annual adjustments with payments being adjusted for time value of money, inflation and tax but believes the in-period determination process could be streamlined.
- Our view is that the use of a model more similar to the RFI would be appropriate.
- The continued focus on in-period incentives to the exclusion of end of AMP RCV does not align with taking a longer-term approach and measure are needed to ensure that the additional costs of maintaining higher standards is not mistaken for inefficiency. See our response to question 5.14 for further explanation.

We are in favour of continued annual adjustments with payments being adjusted for time value of money, inflation and tax. Although we think the in period determination process could be streamlined.

We think that a model more similar to the RFI, where boards are required to essentially self-certify the adjustments through the charges process based on the Annual Performance Report data is appropriate.

The continued focus on in-period incentives to the exclusion of end of AMP RCV adjustments does not align with taking a longer-term approach. Companies should receive sufficient value for long-term investments in performance levels as they cannot bank on getting rewards in future AMPs and the additional costs of maintaining these higher standards may be mistaken for inefficiency. See question 5.14 for further explanation.

5.16 Do you have any wider comments about the ODI framework at PR24?

Neither agree nor disagree – N/A

Key messages

- A framework that calibrates ODIs without taking companies' customer evidence is high-risk and may not lead to defensible results.
- Basing 2024 ODIs on 2022 research may not be appropriate because the macroeconomic situation may evolve in that time.
- We recommend the use of triangulation with the body of evidence developed by companies to ensure that a clear understanding of customer preferences informs the ODIs and so that the ODI is not based on a single piece of research conducted at a point in time.
- We comment further on PCDs in our report in question 6.1 (section 5.7) but believe they need further review to ensure they promote an outcomes based approach and do not lead to more input/output based measure in place of performance commitments.
- We request that all ODI rates are shared in the final methodology, not just those derived from the collaborative customer research, as this is fundamental to a companies understanding of their risk and reward balances.

As mentioned above, the framework for calibrating ODIs without taking into account companies' customer evidence is a high-risk framework that may not lead to defensible results. One specific aspect is the question of how Ofwat will deal with changes in customer views over time. Basing ODIs that are finalised in December 2024 on research conducted in 2022 may not be appropriate as we would expect the macroeconomic situation to evolve over time.

As a result, we recommend triangulation with the body of evidence developed by companies, historically and more recently, to ensure that the customer valuations that inform ODIs are grounded in an understanding of customer preferences that is not just based on a single piece of research conducted at one point in time.

We comment further on PCDs in our report in question 6.1 (section 5.7) but believe they need further review to ensure they promote an outcomes based approach and do not lead to more input/output based measure in place of performance commitments.

We will also comment on the following text in the main draft methodology document (page 61). It says '*We expect to publish initial customer valuations from the collaborative research in autumn 2022, with valuations mapped to common performance commitment definitions by winter 2022-23.'* We request that all ODI rates are published at this stage, not just the common ones from the research, as these are fundamental for a company to understand their overall risk and reward balance. These are also needed as soon as possible – we would expect them to be shared at the time of the final methodology.

Chapter 6 - Setting expenditure allowances

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

Strongly disagree

Key messages - please refer to section 1 of our separate report for our full response

- We have significant concerns about the proposed approach to setting efficient expenditure allowances for PR24. Key concerns are listed below but please refer to our separate report for our full response.
  - The approach set out in appendix 9 of the draft methodology falls short of what is needed if Ofwat is to meet its own objectives and act in accordance with the UK Government SDS.
  - Although Ofwat has presented ambitions to adopt a more outcomes-based regulatory approach, there is only limited progress towards this in PR24.
  - Although we welcome Ofwat's recognition of the risk of an inefficient capex bias for enhancements and its openness to adapting its regulatory approach in PR24 to address this, we strongly reject both options set out in the draft methodology. This is because these options do not recognise the disparity in incentives for the investor.
  - Our view is that the current approach to funding water companies' base expenditure needs further adjustment because it is unlikely to provide a reasonable basis on which to set allowances for the 2025-2030 period and that this has not been sufficiently addressed in the draft methodology. Given Ofwat's financing duty, we consider that Ofwat must satisfy itself that its largely backward-looking approach is appropriate for setting allowances in AMP8 and if not, enable suitable adjustments to be made. However, this is not necessarily done by just including forecast costs in the models.
  - We would like to engage further with Ofwat in relation to the levels of performance funded by totex allowances. Our view is that more thinking is needed in this area and that this should draw on engagement between Ofwat and water companies and careful and detailed analysis. We has commissioned research in this area which provides insight and guidance and would be a valuable input as Ofwat takes its work forwards.
  - Our view is that Ofwat and companies should engage with the questions about what considerations, metrics and tests should be taken into account in deciding which model specifications, and which suites of models, are most appropriate to use to set allowances.
  - There is an important gap in the draft methodology in relation to the application of benchmarking analysis to enhancement initiatives. This is a major concern given the shortcomings at PR19 and Ofwat's aspirations for PR24.

Attached alongside this response is a comprehensive report, setting out our concerns with the proposed approach to setting efficient cost allowances.

Section 1 outlines a few areas of key concerns, then sections 2 to 6 respond in more detail to the points raised in appendix 9.

6.2 What are your views on how we can best align the treatment of third-party costs and revenues?

Neither agree nor disagree – N/A

Key messages

- There are risks with trying to incorporate an assessment of third-party solution funding in the benchmarking, this is discussed in section 6.3 of the attached report.
- We are very supportive of giving companies the flexibility to secure revenue from the most appropriate source. To achieve this, it is important to be very clear how this revenue and totex is allowed and how it flows through reconciliation models. Solutions allowed within the price cap need to be clearly defined and the revenue and totex streams need to be run through the reconciliation models.

We think there are risks with trying to incorporate an assessment of third-party solution funding in the benchmarking, this is discussed in section 6.3 of the report attached to question 6.1.

However, we are very supportive of giving companies the flexibility to secure revenue from the most appropriate source.

We think the best way to do this is to be very clear how this revenue and totex is allowed and how it flows through reconciliation models. Clearly delineating what solutions are allowed within the price cap, and which are not and how the revenue and totex streams that are in or out, of the price cap run through reconciliation models.

This will create a level playing field between funding routes and ensure no perverse incentives exist – which should be the main aim here.

6.3 Do you agree that companies that submit the most stretching and well evidenced business plans should receive the most favourable cost sharing rates at PR24?

Disagree

Key messages

- We welcome the further consideration that Ofwat has given to the cost sharing mechanism since PR19 however we still think the proposed approach to be worse than the simple alternative of setting symmetric rates for all companies. Please see section 2.12 of our separate report for our full response.

We welcome the further consideration that Ofwat has given to the cost sharing mechanism since PR19 however we still think the proposed approach to be worse than the simple alternative of setting symmetric rates for all companies.

We discuss this in section 2.12 of the report attached to question 6.1.

6.4 Do you agree that resilience enhancement should be used to fund companies to manage increasing risks to specific hazards that are beyond their control and not covered by base expenditure and other enhancement areas?

Disagree

Key messages

- We disagree that the only resilience enhancement should relate to funding companies to manage increasing risk for specific hazards beyond their control, although this should clearly be a subset of resilience enhancement totex. Please see sections 3 and 4 of our separate report for our full response.

We disagree that the only resilience enhancement should relate to funding companies to manage increasing risk for specific hazards beyond their control, although this should clearly be a subset of resilience enhancement totex.

An assessment has to be made of what is implicitly allowed within the base models, and anything on top of this needs additional funding, either through enhancement or an ex post modelling adjustment.

Sections 3 and 4 of the report attached to question 6.1 outline our thoughts on how this should be considered.

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

Strongly disagree

Key messages

- We have serious concerns about the proposals in the draft methodology. It is not clear that base allowances fund increased service. This conflates the impact of historic enhancement allowances and productivity efficiency improvements over time. We welcome further discussion on this.
- Please see section 4 of our separate report for our full response.

We have serious concerns with the proposals set out in the draft methodology. We do not think that it is clear that base allowances fund increased service. This conflates the impact of historic enhancement allowances and productivity efficiency improvements over time.
We welcome the further discussion on it as it is a very challenging area.

We set out detailed thoughts on all aspects of this in section 4 of the report attached in response to question 6.1.

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

Strongly disagree

Key messages

- This question is intrinsically linked to question 6.5 above and we have serious concerns about the proposals in the draft methodology. Please see section 4 of our separate report for our full response.

This question is intrinsically linked with question 6.5 and we address all our concerns with this within the detail response to that question.

6.7 Do you agree with our proposed approach to incentivising and funding efficient investment in reducing greenhouse gas emissions and reducing the use of storm overflows?

Strongly disagree

Key messages

- We have significant concerns with the proposals on funding greenhouse gas emission reductions. The proposals will not enable the industry to achieve its stretching 2030 operational net zero target and create a potential perverse incentive on operational emissions at the expense of embodied emissions. Please see section 5.2 of our separate report for our full response.
- We have significant concerns with the proposal on funding the reduction of storm overflow operation. We can see no way in which this expenditure is captured in the data used to inform the econometric assessment. Please see section 5.3 of our separate report for our full response.

We have some significant concerns with the proposals on funding greenhouse gas emission reductions. The proposals will not enable the industry to achieve its stretching 2030 operational net zero target and create a potential perverse incentive on operational emissions at the expense of embodied emissions.

This is discussed in section 5.2 of the report attached in response to question 6.1.

We also have significant concerns with the proposal on funding the reduction of storm overflow operation. We can see no way in which this expenditure is captured in the data used to inform the econometric assessment.

This is discussed in section 5.3 of the report attached in response to question 6.1.

6.8 Do you agree with our proposed approach to implementing nutrient neutrality in the PR24 regulatory framework?

Strongly disagree

Key messages

- We strongly disagree with the proposed approach, as currently expressed, to implementing nutrient neutrality in PR24. However, we also fundamentally disagree with the requirements detailed in Defra's announcement and currently being incorporated in the Levelling Up and Regeneration Bill as these are not in the best interests of customers or the environment.
- Defra's announcement on nutrient neutrality dated 20 July 2022 appears to supersede and contradict the guidance set out in Appendix 9 of the draft methodology and in the section 5.5 entitled: Nutrient Neutrality in England.
- The methodology suggests a nutrient credit approach for developers to contribute towards the capital costs of asset upgrades. This fails to take account of the several considerations including:
    - a practicable mechanism to recognise contribution towards the ongoing operation and maintenance of these long term assets;
    - failure to recognise the additional embodied or operational carbon burden resulting from chemically and energy intensive treatment systems;
    - failure to recognise that water companies will be required to deliver biodiversity net gain where these schemes require planning permission, requiring additional upfront costs and maintenance requirements over a 30-year period;
    - failure to recognise that there are far more beneficial ways of achieving nutrient neutrality than fundamentally unsustainable asset improvements.
- We are concerned about potentially excluding nutrient neutrality from cost sharing.

Defra's announcement on nutrient neutrality dated 20 July 2022 (link) appears to supersede and contradict the guidance set out in Appendix 9 of the draft methodology and in the section 5.5 entitled: Nutrient Neutrality in England. This section details the proposals outlined in Defra's consultation on Environment Act targets which closed at the end of June 2022 and has yet to be considered as part of the parliamentary process.

Wessex Water responded to the joint letter from Defra, Ofwat and EA (issued on 3 May 2022) recognising that paying water companies to build more asset improvements is the wrong solution as it will lead to yet more unsustainable use of chemicals and energy-intensive infrastructure. We need mechanisms to deliver more efficient solutions factoring in outcomes for all of government's nature recovery targets, including nutrients, carbon and biodiversity, as well as affordability.

All sectors need to see the full application of the Polluter Pays Principle. But this needs mechanisms to share costs, enable collaboration and flexibility for sectors to find the most cost-effective solution, such as catchment markets. In particular, water quality outcomes need the EA and NE to determine source apportionment for nutrient reduction for all sectors and develop accreditation for nature-based nutrient reduction schemes. Our response can be found: here

Defra's subsequent announcement on 20 July 2022 appears to supersede this consultation, ignore responses from water companies to this letter requesting information, and will require significant investment in specific locations to reduce nitrogen and phosphorus discharges from water recycling centres with population equivalents greater than 250 to technically achievable limits (TAL). These schemes will need to be delivered by 2030, assuming the Levelling Up and Regeneration Bill receives Royal Assent in the next parliamentary period. The Wessex Water region is particularly environmentally sensitive, resulting in four areas where nutrient neutrality applies: Hampshire Avon catchment (phosphorus), Poole Harbour catchment (phosphorus and nitrogen), Chesil and The Fleet (phosphorus and nitrogen) and the Somerset Levels and Moors phosphorus) as illustrated in the map of impacted protected zones below:

This new requirement, under the Levelling Up and Regeneration Bill, is incompatible with Ofwat's expectation that companies "take account of wider environmental and social benefits, costs, risks and affordability of customers' bills when developing enhancement proposals". It is impossible to achieve these technically achievable limits, enabling permit compliance, with nature-based and catchment solutions. These levels will only be achieved by energy and chemically intensive 'grey' treatment processes which are misaligned with net zero and wider environmental objectives.

By the end of AMP7, in 2025, Wessex Water will have delivered our fair share reductions in phosphorus to achieve compliance with Water Framework Directive requirements in all catchments except for the Bristol Avon where it has been deemed, by the Environment Agency, to be disproportionately costly to do so. This means that any requirements, either under the Environment Act for 80% reductions in phosphorus discharges from water recycling centres, or to achieve TAL, go beyond Wessex Water's contribution and are essentially compensating for other sectors ineffectual actions to date at the expense of the water company customers. These AMP7 investments have been designed and delivered in accordance with a 25-year design horizon, taking account of projected development within those sewerage catchments to c.2050. In section 5.5. this is recognised and suggests that it

is developers who should pay for the additional nutrient neutrality requirements over and above those planned and agreed between water companies and our regulators in PR24, prior to recent Defra announcements:

Under Natural England's guidance, planned environmental improvements in the 2025-30 period that would have happened in the absence of the NN requirement, but nonetheless would lead to an improvement in phosphorous [sic] or nitrogen standards, do not 'count' for NN mitigation. The key principle is that it would be inappropriate for developers to obtain NN mitigation from planned environmental improvements. NN mitigation needs to be separate and incremental to planned environmental improvements to ensure no net deterioration of the relevant site in unfavourable status.

Table 5.1 Two scenarios for how nutrient removal schemes could be treated

Gates	Scenario 1	Scenario 2
1. Was the programme 'planned' in company's WINEP programme in the 2025-30 period?	Yes	Yes
2. What is the driver (ie key reason) for planning the scheme?	Achieving general environmental improvements	Compliance with nutrient neutrality
3. Does Natural England allow the scheme to count as mitigation for nutrient neutrality?	No, because scheme will be part of WINEP programme anyway (see 1)	Yes, because scheme would not have been part of WINEP programme had it not been for NN requirement[138]
4. What is the impact on developers in relation to demonstrating compliance with nutrient neutrality?	Developers need to find an alternative unplanned scheme to demonstrate mitigation for nutrient neutrality; potential reduction in amount of mitigation needed because of general improvement	Multiple developers can contribute towards each scheme, up to the point that the nutrient reduction provided in addition to that required for environmental improvement is 'claimed' as mitigation

These two scenarios suggest that it is developers who should either seek their own measures to ensure the nutrient neutrality of their development (scenario 1) or should contribute towards the financial cost of improvements in water company assets (scenario 2) rather than the wider customer base funding this.

The recent Defra announcement has meant that the following option, from Appendix 9, is now relevant, whereby Ofwat will require a contribution from developers where achieving TAL will assist in delivering their nutrient neutrality requirements:

Our proposed PR24 regulatory approach to NN depends on whether there is a statutory requirement to go further than water companies' environmental obligations in areas affected by NN (such as the potential obligation to achieve TAL at WWTWs):

- if there is an additional NN statutory requirement, **we propose to treat NN mitigation as a price control activity**. The obligation would form part of a total scope of required investments as part of the price control. Whether the investment counts towards NN mitigation depends on whether the work is required to meet existing environmental obligations (scenario 1) or goes further than this (scenario 2). Under scenario 1, the costs would be recovered from customers. Under scenario 2, we would expect a contribution from developers (see below); and
- if there is not an additional NN statutory requirement, **our preferred option is our proposed 2020-25 approach of treating NN mitigation as a non-price control activity** with flexibility for companies and developers to undertake commercial negotiations on any potential nutrient mitigation schemes with minimal regulatory intervention from Ofwat.

The recent blanket requirement to achieve TAL in the four catchments identified in the WW region will, in many cases, go beyond developers' requirements to achieve nutrient neutrality, going beyond fairshare and potentially providing an offset for other sectors, such as agriculture, paid for by water company customers across our region. This also means that developers will not need to seek alternative and more sustainable offset options, such as nature-based solutions which would provide greater environmental and potentially amenity benefits, nor will they need to improve the design of the development to reduce or offset nutrient contributions at source where it is possible to do so, disincentivising sustainable design.

The methodology suggests a nutrient credit approach for developers to contribute towards the capital costs of asset upgrades. This fails to take account of the following considerations:

- A practicable mechanism to recognise contribution towards the ongoing operation and maintenance of these long term assets for the duration of the development, typically cited as 80-120 years in planning law, as would be required by developers contributing towards market based offsetting schemes. It is noted that companies need to 'consider' this with no further detail. It should be recognised that energy and chemical markets are volatile and so projecting 80+ year costs, including asset renewal within this time period, is difficult with any accuracy
- Failure to recognise the additional embodied or operational carbon burden resulting from chemically and energy intensive treatment systems
- Failure to recognise that water companies will be required to deliver biodiversity net gain where these schemes require planning permission, requiring additional upfront costs and maintenance requirements over a 30-year period
- Failure to recognise that there are far more beneficial ways of achieving nutrient neutrality than fundamentally unsustainable asset improvements.

We are also severely concerned about potentially excluding nutrient neutrality from cost sharing. Where these costs will often be at an early stage, and have a lot of uncertainty, this presents a substantial increase in totex risk for the company.

It should be noted that requirements to achieve TAL preclude the opportunity for nature-based solutions as these are unable to achieve the 0.25mg/l total phosphorus and 10mg/l

(subject to change prior to PR24) total nitrogen limits recognised. Therefore, these requirements will be delivered using grey infrastructure alone.

We disagree with the proposed approach, as currently expressed, to implementing nutrient neutrality in PR24. However, we also fundamentally disagree with the requirements detailed in Defra's announcement and currently being incorporated in the Levelling Up and Regeneration Bill as these are not in the best interests of customers or the environment.

Section 5.5 details the cost sharing treatment of nutrient neutrality mitigation totex. In summary, we propose to exclude costs associated with nutrient neutrality mitigation from cost sharing.

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

Disagree

Key messages

- We are concerned that Ofwat's approach may not work well in practice and that it is not yet sufficiently well developed. However, we welcome the attention that Ofwat gives to wider economic benefits in the draft methodology.

We welcome the attention that Ofwat gives to wider economic benefits in the draft methodology. However, we are concerned that Ofwat's approach may not work well in practice and that it is not yet sufficiently well developed.

We discuss this in detail in section 6 of the report attached in response to question 6.1.

6.10 Do you agree with our proposed approach to removing the potential disadvantage that nature-based operating expenditure solutions may face in relation to the treatment of enhancement operating expenditure?

Disagree

Key messages

- This is a key issue for the final methodology. We do not support either of the proposals outlined in the draft methodology as neither addresses the key issue that there is no renumeration for risk for non-capex based solutions.
- Explicitly, the proposed approaches do not remove the disadvantage that nature-based operating expenditure solutions face. Please see section 1.3 of our separate report for our full response.

This is a key issue for the final methodology. It is imperative that a level playing field is created for all types of solutions imposed. We do not support either of the proposals outlined in the draft methodology as neither address the key issue that there is no renumeration for risk for non-capex based solutions and neither generates a level playing field.

We discuss this further in section 1.3 of the report attached in response to question 6.1.

Chapter 7 – Aligning risk and return

Executive summary – risk and return
We welcome the opportunity to respond to the financial aspects of Ofwat's PR24 draft methodology. Our response is structured as follows:

- Section 1 sets out an executive summary to our response on risk and return issues included within the PR24 draft methodology.
- Section 2 provides our detailed responses to risk and return, financeability and financial resilience questions.

The proposed approach to the calculation of cost of equity parameters implies significant changes in methodology which exert downwards pressure on returns, are inconsistent with the CMA's approach at PR19 and are not consistent with risk exposure for water companies at PR24. The scale of this reduction appears to contrast with Ofwat's focus on financial resilience – all else equal the risk and return proposals will most likely reduce the financial resilience of the sector. We are concerned that Ofwat's recent financial resilience licence modification consultation does not consider the inter-dependencies between the calibration of risk and return at each price control and the financial resilience in the sector.

In our response to Ofwat's December discussion paper on risk and return we highlighted a number of inconsistencies in Ofwat's approach to setting the notional company. Overall, we consider that there is not clear evidence to support reducing the notional gearing figure below the 60% at PR19. In recent years the gearing of the water sector has been above 70%. Moreover, the target gearing level for the investment level BBB grade is 55%-70%, and current notional gearing of 60% is at the stronger end of the rating band. The proposed changes to the notional company undermine the notional financeability test as a meaningful cross check on returns and risk allocation. The draft methodology makes an inappropriate assertion regarding how companies should adjust their actual gearing before 2025, with which we disagree.

Overall, the changes proposed in the finance sections of the draft methodology are not in the long-term interests of customers. The draft methodology is likely to reduce the attractiveness of the sector to new investment at precisely the time when significant investment is required to meet climate change and environmental challenges.

Cost of equity
Ofwat's approach to the cost of equity is inconsistent with the CMA's approach at PR19 and omits relevant evidence which results in a downwards skew for each parameter. The scale of the reduction implied in allowed returns will, all else equal, result in pressure on financeability and the ability of the notional company to manage risk.

Extensive analysis was performed on the methodology for setting the cost of equity for the water sector as part of the CMA's PR19 re-determination. Ofwat's proposed approach for PR24 implies material departures from the CMA's approach and places weight on Ofgem's recent decisions in energy which were recently challenged at CMA. There are significant differences between the energy appeals and water re-determination regimes – we consider that the regulatory objective should be to set the right cost of equity based on a balanced assessment of the evidence, rather than to set returns that are 'not wrong'.

In particular, we note that:

- **Risk free rate:** Ofwat has indicated that it will not apply a convenience yield adjustment or forward rate uplift. Ofwat will also not take into account AAAs as part of its estimation of the risk free rate. Ofwat is minded to move away from the 1% RPI-CPIH wedge used at PR19 to a lower value that incorporates a 0 wedge from 2030 onwards.
- **TMR:** Ofwat minded to rely on arithmetic range derived using the overlapping estimator, which results in lower values relative to the case where non-overlapping estimator is also included (a further, new departure from CMA). Ofwat is also proposing not to take into account the RPI back cast series when setting TMR.
- **Beta:** Ofwat is clear it will not attach bespoke weights to Covid-affected data. Ofwat proposes to change its approach to de- and re-levering (a variant on one of Mason & Wright's methodologies).
- **Cross checks:** Ofwat proposes to use Market-to-Asset-Ratios (MARs) to cross check the overall cost of equity which may result in further reductions through selection of a point estimate below the mid-point. The use of MAR as a cross check has significant limitations due to the range of assumptions used when valuing a water company – it is very difficult to derive meaningful information to cross check allowed returns from MAR data.
- **Aiming up:** The CMA at PR19 increased the cost of equity by 25bps to account for investment incentives due to parameter uncertainty, financeability, and asymmetric risk on ODIs (including possible changes in forward-looking risk exposure). Ofwat proposes a high hurdle for aiming up at PR24.

Each of these proposals contribute to a significant downwards adjustment to the cost of equity overall from the recent CMA re-determination at PR19, driven by changes in the methodology proposed rather than changes in the market.

Cost of debt

We do not agree with Ofwat's approach to calculating the cost of embedded debt allowance which relies on a selective approach to estimation of costs for each company (excluding a number of instruments such as swaps and junior debt which contribute to the all-in economic cost) and does not set out clear principles for calculation of sector average costs (the balance sheet approach).

We welcome further clarity on Ofwat's methodology including:

- Rationale for averaging methodology used to estimate sector average costs
- Principles underpinning treatment of outliers

Ofwat's proposal to include an ex ante outperformance wedge for new debt based on tenor and an ex post true up reduces clarity around the benchmark for new debt issuance, increases risk and introduces perverse incentives for the sector to issue short-dated debt in the current macroeconomic environment.

The CMA determined at PR19 that there is no evidence of a material halo effect, and concluded that outperformance against the iBoxx A/BBB 10+ index is driven primarily by two factors (1) credit rating and (2) tenor. The CMA considered that lower tenor in isolation is not sufficient to justify an outperformance wedge. We consider that adjusting the cost of new debt in PR24 for outperformance driven by tenor would incentivise shorter debt tenors, which transfers risk to customers in a rising interest rate environment. An ex post adjustment increases uncertainty and could preclude recovery of efficient costs over the life of each instrument.

Risk analysis and quantification

We welcome Ofwat's renewed focus on risk at PR24. However, we are concerned that the use of sector-wide notional RoRE risk ranges do not take into account company specific characteristics and risks. Second, reliance on backward-looking data may not represent a robust proxy for forward looking risk. Third, the current risk analysis omits long term risks such as risks relating to embedded debt. Fourth, current risk analysis does not accurately consider or reflect all potential drivers of asymmetry. Fifth, it is not clear how risk analysis will translate into changes to risk allocation or returns.

It will be important to consider how changes in risk apply to specific companies across the following dimensions:

- Regulatory risk, covering regulatory discretion risk and objectives and incentives;
- Business drivers, including labour shortages and supply chain challenges;
- Environmental risks, including weather events; and
- Industry drivers, including the transition to Net Zero and growth.
-

Ofwat's assessment that PR24 risks are likely to be symmetric does not appropriately capture the calibration of specific elements of the regulatory framework (for example, the proposed removal of deadbands, caps and collars on ODIs) and implications for risk asymmetry.

Notional structure and financeability

The specification of the notional structure underpins a meaningful financeability cross check on the overall price control and allowed return. The notional company should be set based on appropriate industry benchmarks and corporate finance theory. Ofwat's proposed changes to the notional structure - including a reduction in notional gearing, increase in the proportion of index linked debt, retention of RPI linked debt within the notional structure alongside a full transition to CPIH - undermine financeability as a robust and meaningful cross check.

The principles applied by Ofwat to set the notional capital structure are not clear and we disagree with the following changes:

- Reduction in notional gearing (departing from the sector average position)
- Increase in the proportion of index linked
- Mismatch between RPI linked debt assumed for the notional company and CPIH linked assets
- No pricing for hedging of RPI / CPIH basis risk arising from full transition to CPIH

Q7.1. Do you have any comments on our approach to the overall balance of the PR24 incentive package, our proposed guidance on producing risk ranges, and our view of the balance of risk facing the notional company?

Strongly disagree

Key messages

- The proposed approach risks a mismatch between risk exposure and the level of returns at PR24 because of the following factors:
  - the use of sector-wide notional RoRE risk ranges do not take into account company specific characteristics and risks;
  - backward-looking data may not represent a robust proxy for forward looking risk;
  - the proposed approach omits long term risks such as risks relating to embedded debt and more generally is constrained to the next price control only;
  - current risk analysis does not accurately consider or reflect all potential drivers of asymmetry; and
  - it is not clear how risk analysis will translate into changes to risk allocation or returns.
- Risk asymmetry is not appropriately priced.

Ofwat has not set out robust approach to analysis of risk at this stage, and we consider that the proposed approach risks a mismatch between risk exposure and the level of returns at PR24, driven by the following factors:

- The use of sector-wide notional RoRE risk ranges do not take into account company specific characteristics and risks.
- Backward-looking data may not represent a robust proxy for forward looking risk.
- The proposed approach omits long term risks such as risks relating to embedded debt and more generally is constrained to the next price control only
- Current risk analysis does not accurately consider or reflect all potential drivers of asymmetry.
- It is not clear how risk analysis will translate into changes to risk allocation or returns.

Ofwat has indicated that at least the same revenues will be at risk at PR24 as at PR19, which suggests that allowed equity returns should be at least equal to PR19. Based on Ofwat's draft methodology the increase in risk exposure does not appear to match the proposed approach to pricing risk in the allowed return, which all else equal will leave companies more exposed to downside risks and provide less headroom for the management of downside risks.

Sector wide notional risk ranges do not capture company specific risk

The starting point for price control calibration should be development of clear understanding of risk and we welcome Ofwat's focus on risk at PR24.

We do not agree with Ofwat's approach to setting the RoRE ranges at a sector level as this do not take into account specific company characteristics which it cannot control and associated risks. This includes environmental commitments, population growth and regional differences. We propose that Ofwat's risk analysis considers a notional company *like* Wessex Water.

If Ofwat adopts our proposed Outcomes Based Environmental Regulation (OBER) framework this would likely imply heightened risk exposure. This risk would need to be priced.

Backward looking analysis does not capture changing risk exposure at PR24
A great deal has changed since PR19, both in terms of the regulatory landscape, and in respect of the operating and commercial environment. These fundamental shifts have significant implications for water company risk and pricing, including *inter alia*:

- Enhanced required response to climate change and environmental changes that underpin heightened operational risks and greater challenges to maintain resilience. Non-compliance with regulatory standards and wider TCFD risks can drive material financial exposure;
- Introduction of competition and changes to business models, removal of regulatory protections (e.g. ability for companies to exclude extreme weather events from incentives)
- Significant investment requirements to address major operational challenges such as storm overflows, new water resources, greater connectivity and to deliver Net Zero; and
- Substantial pressure on supply chains, materials costs and labour markets alongside changes in technology, as well as more stretching efficiency challenges on base costs.

Risk asymmetry is not appropriately priced
We note that the total potential upside and downside, as presented in Ofwat's RoRE ranges, does not reflect asymmetric risk in the price control. Calibration of individual incentive targets, caps and collars and deadbands will inform the overall likelihood of out or underperformance and ultimately the symmetry or asymmetry of the price control. It is not clear how these potential drivers of asymmetry are captured under Ofwat's approach. We discuss this more in response to question 5.13.

Q7.2. Do you agree with our proposals on the regulatory regime for managing companies' exposure to uncertainty over 2025-30?

Disagree

Key messages

- We support companies taking on risks that they are best placed to manage and which they can control.
- Key areas of increased risk going into PR24 are not within management control e.g. increasing energy costs and high inflation.
- We suggest the use of Retail Price Effects (RPEs) at 2024 with a true up at the end of the price control. There is extensive regulatory precedent for the use of RPEs.

We support companies taking on risks they are best placed to manage and which they can control. Risks allocated to companies should be priced through allowed returns.

There is increasing uncertainty over our expenditure as we enter PR24 given a number of factors including the Net Zero transition, increasing energy costs and high inflation. We believe that companies should take the risk they are best placed to manage, however some of the key areas of increased risk, such as energy costs, are not fully within management control.

We suggest increased use of Real Price Effects (RPEs) at PR24 with a true up at the end of the price control. Specifically we consider the use of RPEs for energy costs would more appropriately balance the risk of market movements between companies and customers. There is extensive regulatory precedent for the use of RPEs, Ofwat introduced the wage true up at PR19 and RPEs for labour and materials are used by Ofgem for its RIIO-2 price control.

Q7.3. Is there value in introducing more prescriptive requirements and guidance for company produced RoRE risk ranges?

Neither agree nor disagree – N/A

Key messages

- More detailed guidance on RoRE ranges would improve the comparability of risk analysis and quantification across the sector. The guidance for company-produced RoRE ranges should be primarily principles-based, with potentially more prescriptive requirements for parameters that are common across companies.
- We suggest that guidance on risk analysis at PR24 should be based on a set of principles for assessing risk rather than prescriptive guidance. This approach will underpin a robust understanding of the underlying risks faced by companies, including company specific characteristics and implications for risk, this could differ by company across the sector. We set out below a framework for considering risk at PR24:
    - First, consider actual risk exposure over PR19 considering operational performance, including totex and ODIs, and macroeconomic risk and how these risks translate to financial exposure;
    - Second, consider how this risk exposure translates to financial exposure based on the PR24 methodology compared to the PR19 methodology including totex allowances, the allowed return and calibration of ODIs.
    - Third, we would consider risk drivers which are new or increasing over PR24 both for the sector overall and for Wessex specifically due to our company's characteristics.
- Regarding implementation:
    - It will necessary to consider the relationship between cost and service in part on a company specific basis;
    - It will be necessary to map risk drivers for each ODI and understand the interaction between these risk drivers across the incentive package as a whole; and
    - The starting point should be a conceptual mapping of the relationships between risk drivers and how risk drivers link to different incentives and costs to build a map of key interrelationships between risks and incentives. Each significant interrelationship will need to be translated into specific measures of correlation based on either past performance data or tools which can capture expert evidence from the business on relationships between risks.
- Our view is that at this stage, it is more appropriate to focus on individual scenarios which could create exposure rather than stochastic modelling to map the interactions between all ODIs. This could be based on common principles and guidance around evidence which could be used to corroborate and quantify exposure.

More detailed guidance on RoRE ranges would improve the comparability of risk analysis and quantification across the sector. The guidance for company-produced RoRE ranges should be primarily principles-based, with potentially more prescriptive requirements for parameters that are common across companies.

This could allow for greater comparability on common parameters and flexibility to tailor the analysis for company-specific characteristics and circumstances; the latter being critical to obtain a complete and accurate picture of risks faced by the sector. Imposing prescriptive guidance across all elements of the risk analysis would likely result in artificial comparability and significantly undermine the value of company-produced analysis.

In practice risk ranges will differ between companies based on company characteristics including, but not limited to, investment programme, regional differences and design of regulation such as OBER.

As a result we do not see the benefit of producing notional risk ranges for a generic "efficient notional company". Risk analysis should be based on the underlying drivers of risk and there may be merit in common techniques for robustly quantifying exposure for PR24. However risk quantification needs to reflect company specific risk drivers.

We suggest that guidance on risk analysis at PR24 should be based on a set of principles for assessing risk rather than prescriptive guidance. We set out below a framework for considering risk at PR24:

- First, we would consider actual risk exposure over PR19 considering operational performance, including totex and ODIs, and macroeconomic risk and how these risks translate to financial exposure.
- Second, we would consider how this risk exposure translates to financial exposure based on the PR24 methodology compared to the PR19 methodology including totex allowances, the allowed return and calibration of ODIs.
- Third, we would consider risk drivers which are new or increasing over PR24 both for the sector overall and for Wessex specifically due to our company's characteristics.

This approach will underpin a robust understanding of the underlying risks faced by companies, including company specific characteristics and implications for risk, this could differ by company across the sector.

a) **How might this be implemented for interactions between performance on cost and service?**
b) **How might this be implemented for interactions between performance on different ODIs?**

The relationships between ODIs may differ between water companies due to specific company characteristics, the nature and scale of past investment and risk drivers specific to a company's service area. These differences could result in significant variances in how risks manifest and the cost to maintain or improve service levels under different operational scenarios. We consider that it will necessary to consider the relationship between cost and service in part on a company specific basis. We discuss this more in our responses on setting efficient expenditure allowances.

External factors outside of management control can impact on PR24 incentive performance – and the correlations between different incentives are complex. It will be necessary to map risk drivers for each ODI and understand the interaction between these risk drivers across the incentive package as a whole. For example, under dry conditions we would anticipate our performance on flooding would improve but we would see a reduction in performance on per capita consumption.

We suggest that the starting point should be a conceptual mapping of the relationships between risk drivers and how risk drivers link to different incentives and costs to build a map of key interrelationships between risks and incentives. Each significant interrelationship will need to be translated into specific measures of correlation based on either past performance data or tools which can capture expert evidence from the business on relationships between risks.

We consider it more appropriate at this stage to focus on individual scenarios which could create exposure rather than stochastic modelling to map the interactions between all ODIs.

This could be based on common principles and guidance around evidence which could be used to corroborate and quantify exposure.

Q7.4. Do you agree with our proposed approach to setting the allowed return on equity?

Strongly disagree

Key messages

- The proposed approach to setting the cost of equity at PR24 is based on a number of significant changes from the methodologies employed by the CMA in PR19. The methods selected appear to introduce a downward bias to the cost of equity estimate.
- The proposed changes imply a reduction in the cost of equity which does not seem to be supported by market evidence and is driven primarily by methodological changes.
- We provide further details on our concerns with RFR, TMR, the beta, and our support of Ofwat's approach with regards to inflation.

Ofwat's proposed approach to setting the cost of equity at PR24 is based on a number of significant changes from the methodologies employed by the CMA at PR19. On almost all parameters Ofwat appears to selectively apply methods that are likely (on their own and in combination) to introduce downward bias to the cost of equity estimate. We have included below our commentary on each parameter and cross reference Water UK work on the cost of equity where relevant.

The reduction in the cost of equity implied by the proposed changes does not appear to be supported by market evidence and is driven primarily by methodological changes – particularly the exclusion of the RPI back series when calculating TMR, inclusion of Covid data to calculate beta, a new approach to the de and re-levering question and the removal of aiming up.

Risk free rate (RFR)
Our concerns are highlighted in the work co-ordinate by WaterUK and published at the following locations on the Ofwat Future Ideas Lab:

https://www.ofwat.gov.uk/wp-content/uploads/2022/08/NWG_Risk_Free_Rate_FE.pdf

https://www.ofwat.gov.uk/wp-content/uploads/2022/08/NWG_Risk_Free_Rate_Oxera.pdf

Total market return (TMR)
We disagree with the proposal to disregard the RPI series for deflating historical TMR on the basis that both CPIH and RPI have relevant strengths and weaknesses which means that weight should be placed on both.

RPI actual values are available for a longer proportion of the historical window, but the formula is known to have varied over time and it is not the best measure of inflation going forward. CPIH is a more reliable measure of inflation, however, the quality of the CPIH back series published in May needs to be reviewed. We note that the modelled CPI series required revisions[3].
As a result, weight should be placed on both RPI and CPIH series; to do otherwise risks introducing a bias through omission of relevant data. This is consistent with the approach adopted by the CMA at CMA21.

[3] Consumer Prices Index including owner occupiers' housing costs (CPIH) historical series - Office for National Statistics

On averaging, there is no rationale to diverge from the approach adopted by the CMA, which focused on arithmetic averages and considered overlapping and non-overlapping estimators of returns over 10- and 20-year holding periods. We note that the CMA carefully considered the arguments for and against the inclusion of the non-overlapping estimator and concluded that these should be included "in the range of reasonable TMR estimates, rather than to exclude some of these estimates as to do so may risk 'cherry-picking' data"[4].

Ofwat also proposes to retain the use of a direct transformation of the whole-period geometric average return to its arithmetic equivalent as a cross-check. We note that CMA21 revealed challenges in estimating the appropriate uplift to the geometric mean[5], so this approach would need to be applied with caution and may be of limited usefulness.

Beta

Our concerns are highlighted in the work co-ordinate by WaterUK and published at the following locations on the Ofwat Future Ideas Lab:

https://www.ofwat.gov.uk/wp-content/uploads/2022/08/NWG_Estimation_of_beta_and_treatment_de_and_relevering.pdf

Cross checks and MAR

Our concerns are highlighted in the work co-ordinate by WaterUK and published at the following locations on the Ofwat Future Ideas Lab:

https://www.ofwat.gov.uk/wp-content/uploads/2022/08/NWG_Cross_Checks_for_the_Cost_of_Equity_MARS.pdf

https://www.ofwat.gov.uk/wp-content/uploads/2022/08/NWG_Cross_Checks_for_the_Cost_of_Equity_Multi_factor_models.pdf

Inflation

We welcome Ofwat's proposal to retain its current approach to use long run inflation assumptions when setting the cost of capital.

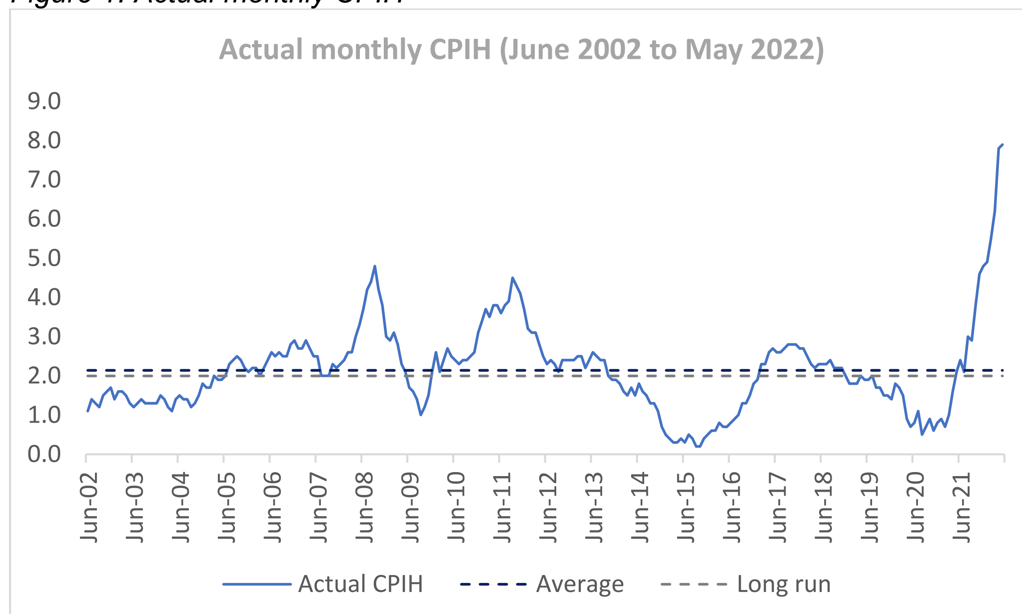
By using the long run inflation assumption in setting the cost of capital, investors are exposed to symmetric risk to movement in outturn inflation relative to long term forecasts.

[4] CMA (2021), PR19 FD, para. 9.333

[5] Ibid. paras. 9.334 – 9.338

Figure 1 below shows actual CPIH over the last twenty years. This chart shows that although actual CPIH fluctuates above and below the long run assumption of 2.0% the average CPIH over the period, 2.1%, is in line with the long run assumption.

Figure 1: Actual monthly CPIH



Inflation risk protection is an important element of the regulatory model that investors rely on and one that has supported the lowering of the WACC relative to sectors that bear inflation exposure. All else equal, the required return would need to increase to compensate for the erosion of this protection. We do not consider this to be in the customer interest.

Equity investors in the sector have long term investment horizons, with the expectation of regulatory stability and predictability. Over the life time of an investment, investors will expect to be exposed to long run inflation on average over time. The estimation of WACC for a long-term horizon, which requires consistency of assumptions across parameters to ensure it can be representative of the true required return over the horizon. Use of short term data could undermine this.

Q7.5. Do you agree with our proposed approach to setting the allowed return on debt?

Strongly disagree

Key messages

- We do not agree with Ofwat's approach to exclude index-linked swaps and junior debt from the sector average methodology, the lack of clarity around how the sector average will be calculated (including averaging methodology and the companies which will be included) and the inclusion of an outperformance wedge.
    - Although at a high level Ofwat's approach is consistent with the CMA's approach to setting the cost of debt in PR19, differences in the detail could result in the omission of relevant costs and a material reduction in the cost of debt allowance.

  We make further comments on our concerns over the treatment of the cost of embedded debt, the cost of new debt and insurance and liquidity costs, and agree with the approach on new debt proportion.

Ofwat has adopted an approach which is consistent with the CMA's approach to setting the cost of debt at PR19 at the highest level but a number of departures in the detail could result in omission of relevant costs and a material reduction in the cost of debt allowance.

We do not agree with Ofwat's approach to exclude index-linked swaps and junior debt from the sector average methodology, lack of clarity around how the sector average will be calculated (including averaging methodology and the companies which will be included) and the inclusion of an outperformance wedge.

Cost of embedded debt

There is material uncertainty in Ofwat's methodology around the approach which will be used to set the cost of embedded debt allowance. It is critical Ofwat sets out a clear ex ante methodology which will capture the actual cost of debt for the sector. We have set out below the key elements of the methodology which will need to be defined.

First, Ofwat has not set out the averaging methodology which will be used to calculate the sector average. We consider it appropriate to follow the CMA's methodology at PR19 to use the median to calculate the sector average. Other approaches such as an RCV weighted average approach will place disproportionate weight on financing strategies adopted by larger companies.

Second, it is not clear which companies will be included in the calculation of the sector average. At PR19, the CMA included WASCs and large WOCs within the balance sheet approach to calculate the cost of debt. Within the draft methodology, Ofwat stated that the sector allowance *"will be informed by the large companies"*[6], however it is not clear if this refers to WASCs only or also includes large WOCs, it is also not clear how Ofwat will treat outliers. We consider it appropriate for all WaSCs and large WoCs to be included in the sector average calculation for the cost of embedded debt.

Third, the methodology implies a selective approach to the treatment of instruments included within the sector average. Ofwat has set out that swaps (other than cross currency swaps) and junior debt should be excluded from the sector average calculation. At the PR19

[6] Ofwat (2022), Draft methodology appendix 11 allowed return on capital, page 29

redetermination, the CMA included all instruments within the sector average calculation (making adjustments for specific elements which may skew the data e.g. higher drawn down amounts on RCF due to Covid). We do not see a clear basis to deviate from the CMA's approach.

Cost of new debt
The CMA determined at PR19 that there is no evidence of a material halo effect, and concluded that outperformance against the iBoxx A/BBB 10+ index is driven primarily by two factors (1) credit rating and (2) tenor. The CMA considered that lower tenor in isolation is not sufficient to justify an outperformance wedge. We consider that adjusting the cost of new debt in PR24 for outperformance driven by tenor would incentivise shorter debt tenors, which transfers risk to customers in a rising interest rate environment. An ex post adjustment increases uncertainty and could preclude recovery of efficient costs over the life of each instrument.

Issuance and liquidity costs
Ofwat has proposed a 10bps allowance for issuance and liquidity costs for PR24. This approach does not appropriately price the RPI-CPIH hedging risk introduced by Ofwat's full transition to CPIH whilst the majority of index-linked debt in the sector remains RPI linked. At PR19 Ofwat stated that *"maintaining investor confidence required us to allow for an unwinding of the embedded RPI based debt over time"*[7]*.* However, it has departed from this rationale by implementing a full transition to CPIH for the RCV and revenues but not pricing RPI linked debt at PR24.

This issue is particularly important due to the current volatility in the macroeconomic environment, where we are observing significant risk exposure due to movements in the difference between RPI and CPIH.

Ofwat's approach also does not factor in cost of carry, in contrast to for example Ofgem which at RIIO-2 has priced in c.25bps for issuance and liquidity costs, RPI-CPI basis risk and cost of carry.

New debt proportion
We agree the proportion of new debt for PR24 should reflect the anticipated PR24 investment and RCV growth, as well as any changes to the notional capital structure (which we comment on separately).

[7] https://www.ofwat.gov.uk/wp-content/uploads/2017/12/Appendix-12-Risk-and-return-CLEAN-12.12.2017-002.pdf, page 95

Q7.6. What are your views on the options we have set out for estimating the RPI-CPIH wedge for converting RPI-linked yields to a CPIH basis?

Neither agree nor disagree

Key comments

- Our concerns are highlighted in the work co-ordinate by WaterUK and published on the Ofwat Future Ideas Lab.

Our concerns are highlighted in the work co-ordinate by WaterUK and published at the following locations on the Ofwat Future Ideas Lab:

https://www.ofwat.gov.uk/wp-content/uploads/2022/08/NWG_Risk_Free_Rate_FE.pdf

https://www.ofwat.gov.uk/wp-content/uploads/2022/08/NWG_Risk_Free_Rate_Oxera.pdf

Q7.7. Do you agree with our proposed approach to the notional structure and setting allowances for corporation tax?

Strongly disagree

Key messages

- The notional company should be set based on appropriate industry benchmarks and corporate finance theory.
- CPIH indexation - we agree with Ofwat's approach to fully transition to CPIH at the beginning of AMP8.
- Notional gearing – we do not agree with Ofwat's proposed reduction in notional gearing. The notional gearing should be set based on market evidence, and sector gearing is approximately 66 per cent.
- Proportion of ILD - the approach for setting parameters for the notional company should be internally consistent.
- Mix of RPI and CPIH ILD for the notional company - Ofwat has indicated that the notional company will be assumed to have a mix of RPI and CPIH linked debt. This approach results in a fundamental mismatch between CPIH linked assets and RPI linked liabilities for the notional company, with no pricing of this risk in the cost of debt allowance.
- Corporation tax – we agree with Ofwat's approach to calculating tax allowances and welcomes the introduction of the geometric uplift methodology. However, we await further clarification of the methodology for the PR19 tax reconciliation mechanism and the approach to capital allowances at PR24.

The calibration of the notional structure is pivotal for a meaningful financeability cross check on the overall price control and allowed return. The notional company should be set based on appropriate industry benchmarks and corporate finance theory.

CPIH indexation
We agree with the Ofwat's approach to fully transition to CPIH at the beginning of AMP8.

Notional gearing
We do not agree with Ofwat's proposed reduction in notional gearing. The notional gearing should be set based on market evidence, and sector gearing is approximately 66 per cent. The reduction in the notional gearing could lead to market distortions due to (1) equity issuance costs; (2) a reduction in the proportion of embedded debt which could increase the cost of debt allowance, and hence increase costs for customers; and (3) companies adopting inefficient capital structures.

If Ofwat is concerned about companies' ability to manage downside risk it should address the risk at source, through calibration of totex allowance and incentives, or price this risk through the cost of capital.

Our gearing has reduced by c. 3% in FY22 due to the high inflation environment. This reduction in gearing may reverse in AMP8 to finance the enhancement programme. It is not inappropriate to translate volatility arising from high inflation with a permanent step change in the sector's gearing in the long term.

Our concerns are highlighted in the work co-ordinate by WaterUK and published at the following locations on the Ofwat Future Ideas Lab:

https://www.ofwat.gov.uk/wp-content/uploads/2022/08/NWG_Setting_Notional_Gearing.pdf

Proportion of ILD
The approach for setting parameters for the notional company should be internally consistent. If Ofwat is using the sector average to inform the proportion of index linked debt this should also be the approach applied to notional gearing – which would need to increase from 60% to 66%.

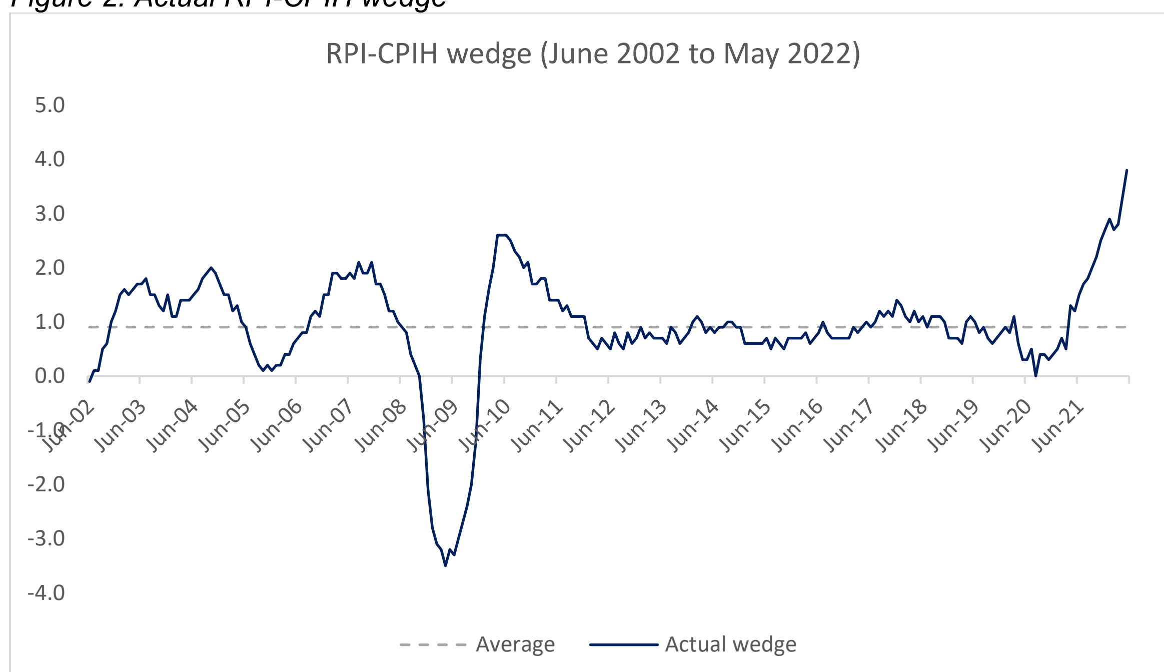
An increase in the proportion of ILD for the notional company will, all else equal, improve the financeability test over PR24 as the cash interest costs incurred will be lower. Any changes to the notional company which impacts on the financeability cross check should be carefully considered to ensure the robustness of the financeability cross check is not undermined.

Mix of RPI and CPIH ILD for the notional company
Ofwat has indicated that the notional company will be assumed to have a mix of RPI and CPIH linked debt. This approach results in a fundamental mismatch between CPIH linked assets and RPI linked liabilities for the notional company, with no pricing of this risk in the cost of debt allowance.

The inclusion of RPI linked liabilities and fully CPIH linked revenues will result in an artificially favourable financeability assessment as RPI linked debt has a lower real coupon and hence lower cash interest costs than CPIH linked debt. This mismatch undermines the notional financeability test as there is no basis to assume that the notional company would support material mismatch between assets and liabilities.

The chart below shows the wedge between RPI and CPIH over the past twenty years. This chart shows there is significant volatility in the wedge between RPI and CPIH over time. Ofwat's approach to include RPI linked debt for the notional company introduces significant basis risk for companies over AMP7 which has not been priced within the cost of debt allowance. This risk is amplified as companies will only be exposed to this mismatch for one price control period and are therefore exposed to increase risk of a high or low wedge in the short term.

Figure 2: Actual RPI-CPIH wedge



Corporation tax
We agree with Ofwat's approach to calculating tax allowances and welcome the geometric uplift methodology introduced to remove the iteration of tax calculations. We await further clarification of the methodology for the PR19 tax reconciliation mechanism and the approach to capital allowances at PR24.

First, Ofwat has not yet published an updated PR19 model to perform the tax reconciliation due to changes in the tax rate and the introduction of super deductions. Further clarification is required from Ofwat on how this true up will be calculated.

Second, Ofwat's financial model includes three capital allowance pools (2%, 6% and 18%). It is not clear how the closing pool balances for the super deductions pool will be treated in the opening balances for PR24.

Chapter 8 – Aligning risk and return: Financeability

Q 8.1. Do you agree with our approach to assessing financeability?

Strongly disagree

Key messages

- Our view is that Ofwat's proposed changes to the notional structure - including a reduction in notional gearing, increase in the proportion of index linked debt, retention of RPI linked debt within the notional structure alongside a full transition to CPIH - undermine financeability as a robust and meaningful cross check.
- We disagree with the following changes to the principles:
  1. Reduction in notional gearing (departing from the sector average position)
  2. Increase in the proportion of index linked debt
  3. Mismatch between RPI linked debt assumed for the notional company and CPIH linked assets
  4. No pricing for hedging of RPI / CPIH basis risk arising from full transition to CPIH
- In our view, it is important to evaluate financeability based on the PR19 notional structure to isolate impacts of a reduction in the allowed return on financeability.

The specification of the notional structure underpins a meaningful financeability cross check on the overall price control and allowed return. The notional company should be set based on appropriate industry benchmarks and corporate finance theory. Ofwat's proposed changes to the notional structure - including a reduction in notional gearing, increase in the proportion of index linked debt, retention of RPI linked debt within the notional structure alongside a full transition to CPIH - undermine financeability as a robust and meaningful cross check.

The principles applied by Ofwat to set the notional capital structure are not clear and we disagree with the following changes:

- Reduction in notional gearing (departing from the sector average position)
- Increase in the proportion of index linked debt
- Mismatch between RPI linked debt assumed for the notional company and CPIH linked assets
- No pricing for hedging of RPI / CPIH basis risk arising from full transition to CPIH.

We therefore consider it important to evaluate financeability based on the PR19 notional structure to isolate impacts of a reduction in the allowed return on financeability.

It will be important for Ofwat and companies to also assess notional financeability at PR24 based on a counter factual scenario using the PR19 notional structure. This analysis will allow Ofwat and companies to isolate changes in financeability driven by (1) notional capital structure changes or (2) changes in risk exposure or price control calibration. The counter factual analysis will ensure a robust financeability cross check is performed to inform the calibration of the price control overall, and specifically the allowed return.

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

Strongly disagree

Key messages

- We strongly disagree: financeability should be a wider assessment than purely looking at limited credit rating agency metrics – this focuses financeability purely on debt finance whereas it should be a much more holistic assessment.
- We also note the importance of recognising the difference between financeability and financial resilience, which we discuss in detail in section 9.
- We agree that the metrics outlined in section 8.4 could be used as part of the assessment of financeability. The metrics should be calculated on a basis which is consistent with the relevant rating agency methodologies. The following equity metrics should also be included:
  - dividend yield
  - payout ratios
  - hedge ratios
  - equity buffer vs risk exposure
- Ofwat should target some headroom for the notional company above the minimum thresholds to ensure there is appropriate headroom for the management of downside risk.
- The thresholds for individual metrics and the scorecard approach should both be considered when assessing financeability based on these credit metrics. Each rating agency has a primary metric (e.g. Moody's AICR), the thresholds for these metrics should be considered as well as the average metrics as rating agencies consider certain metrics to be binding and could downgrade a company based on the primary metric.

Financeability should be a wider assessment than purely looking at limited credit rating agency metrics – this focuses financeability purely on debt finance whereas it should be a much more holistic assessment and therefore disagree with the approach.

However, we agree with the metrics outlined in section 8.4 should be used as part of this more holistic wider assessment. These metrics should be calculated on a basis which is consistent with the relevant rating agency methodologies. In addition, we consider equity metrics including (1) dividend yield (2) payout ratios (3) hedge ratios (4) equity buffer vs risk exposure should be included in the suite of metrics.

The thresholds used by Ofwat for the financeability assessment should be consistent with those used by the rating agencies and Ofwat should target some headroom for the notional company above the minimum thresholds to ensure there is appropriate headroom for the management of downside risk.

The thresholds for individual metrics and the scorecard approach should both be considered when assessing financeability based on these credit metrics. Each rating agency has a primary metric (e.g. Moody's AICR), the thresholds for these metrics should be considered as well as the average metrics as rating agencies consider certain metrics to be binding and could downgrade a company based on the primary metric.

Q 8.3. Do you agree with our proposed approach to cost recovery, in particular that we set a narrow range for RCV run-off rates within which companies will be required to evidence their choice of rate which best achieves a fair balance between current and future customers?

Strongly disagree

Key messages

- We do not agree with Ofwat's approach to introduce a range for run-off rates and a higher bar of evidence to change PAYG rates at PR24.
- Run-off
    - There are multiple methodologies that can be used for calculating run-off rates. Ofwat has emphasised the use of remaining asset lives which does not appropriately reflect the other methodologies and may result in the distortion of natural run-off rates.
    - Within the draft methodology, Ofwat compares the allowances for renewals and maintaining the asset base with the level of cost recovery over PR19. However, this analysis does not accurately reflect the actual renewals and maintenance costs incurred by companies. To align cost recovery and renewals and maintenance expenditure more closely Ofwat should look to the cost allowances to appropriately remunerate companies for the costs incurred rather than seeking to artificially reduce run-off rates.
    - Our view is that Ofwat has proposed an overly prescriptive approach to run-off rates in contrast to its preference to fund opex based solutions through RCV. Ofwat states in the draft methodology that it "wants to incentivise less capital-intensive solutions, where they are the best value approach" . However, companies will not seek these types of solutions if we are unable to recover the costs through adjusting run-off rates.
- PAYG
    - Ofwat's proposals to introduce a higher bar for changes to PAYG rates between price controls does not reflect the evolution of the actual costs we face as a business. There are multiple drivers of the mix between operating and capital expenditure which evolve over time.
- To deliver under the OBER framework, there needs to be flexibility over the type of solutions delivered (opex/capex) and how returns are set.

We do not agree with Ofwat's approach to introduce a range for run-off rates and a higher bar of evidence to change PAYG rates at PR24. This approach seeks to align cost recovery across the sector without taking due consideration for past totex allowances and cost recovery rates.

Run-off

There are multiple methodologies which can be used for calculating run-off rates, the following data sources can be used by companies to determine rates for each control:

- Most recent asset revaluations (GMEAV on CCA basis);
- Information from statutory accounts on annual depreciation charges alongside useful economic lives from the asset register (HCA basis);
- Historical (and forecast) capital maintenance expenditure (CCA basis) excluding enhancements as this should match natural run-off on a BAU basis; and

- Other regulatory precedent and publicly available information such as asset lives and capital maintenance levels.

Ofwat's emphasis on the use of remaining asset lives does not appropriately reflect the other methodologies which could be used to determine run-off rates. This approach may result in a distortion of our natural run-off rates.

Within the draft methodology Ofwat compares the allowances for renewals and maintaining the asset base with the level of cost recovery over PR19. However, this analysis does not accurately reflect the actual renewals and maintenance costs incurred by companies. To align cost recovery and renewals and maintenance expenditure more closely Ofwat should look to the cost allowances to appropriately remunerate companies for the costs incurred rather than seeking to artificially reduce run-off rates.

The overly prescriptive approach to run-off rates is in contrast to our preference to fund opex based solutions through the RCV. Ofwat states in the draft methodology that it *"wants to incentivise less capital-intensive solutions, where they are the best value approach"*[8]. However, companies will not seek these types of solutions if we are unable to recover the costs through adjusting run-off rates.

PAYG

Ofwat's proposals to introduce a higher bar for changes to PAYG rates between price controls does not reflect the evolution of the actual costs we face as a business. There are multiple drivers of the mix between operating and capital expenditure which evolve over time.

For example, we are currently seeing increased pressure on operating expenditure due to increasing energy costs. These type of market changes, which are not within management control, will result in a change to the natural PAYG rates and need to be reflected in allowances to ensure we are able to recover our efficient costs.

Implications for OBER

Under the OBER framework, it is important that there is an incentive to consider operating cost based solutions rather than traditional capital intensive methods. To deliver under this framework there needs to be flexibility over the type of solutions delivered (opex/capex) and how returns are set.

[8] Ofwat (2022), PR24 draft methodology main document, page 17

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

Disagree

Key messages

- It is Ofwat's duty set a price control in which an efficient company can earn a fair return. If the notional company is needing to restrict dividends or inject equity, earning a lower return, to ensure financeability then we think this is a sign of broader problems within the settlement.

Its Ofwat's duty set a price control in which an efficient company can earn a fair return. If the notional company is needing to restrict dividends or inject equity, earning a lower return, to ensure financeability then we think this is a sign of broader problems within the settlement.

The proposed changes to the notional structure are already imposed to resolve financeability constraints, creating additional headroom by lowering gearing and increasing the proportion of index linked debt.

Therefore, when considering the underlying cause of the constraint it is essential that the key price control parameters, such as the WACC are also considered.

Chapter 9 – Promoting financial resilience

Q9.1. Do you agree with the proposed standard set of scenarios for testing financial resilience?

Agree

Key messages

- We are responding separately to the overall approach to financial resilience and ring fencing. Our responses to that consultation should be assumed to take precedence over this consultation as our work is ongoing. However, we discuss some areas below.
- The proposed set of scenarios for testing financial resilience appear to represent a good starting point for our analysis however it has significant limitations as it does not capture Wessex specific risks. We will also include Wessex specific scenarios linked to our principle risks.
- There is a risk that the analysis of the financial resilience scenarios performed across the sector is inconsistent because Ofwat has not included actual financing structure functionality within the PR24 model published alongside the draft methodology. We would welcome development of the PR24 model to incorporate actual financing structure functionality.

The proposed set of scenarios for testing financial resilience appear to represent a good starting point for our analysis however it has significant limitations as it does not capture Wessex specific risks.

We welcome the range of inflation scenarios developed. However we note a high inflation environment is not necessarily beneficial for companies due to the mismatch between RPI linked liability and CPIH linked assets and the non-linear increases in input costs above inflation.

In addition to the Ofwat prescribed scenarios we will also include Wessex specific scenarios linked to our principal risks. These scenarios will be in line with the analysis previously performed for the annual viability statement and will draw on a range of downside categories, including, a credit rating downgrade, exceptional costs such as regulatory fines, pension liabilities and costs associated with unfunded obligations.

There is a risk that the analysis of the financial resilience scenarios performed across the sector is inconsistent as Ofwat has not included actual financing structure functionality within the PR24 model published alongside the draft methodology. We would welcome development of the PR24 model to incorporate actual financing structure functionality to ensure consistency of analysis across the sector.

Q9.2. Do you agree with our approach to how the board of the company should approach its board assurance statement?

Disagree

Key messages

- We are responding separately to the overall approach to financial resilience and ring fencing. Our responses to that consultation should be assumed to take precedence over this consultation as our work is ongoing. However, we discuss some areas below.
- We agree in principle that company boards should consider and provide assurance on financial resilience. However, the assessment is dependent on Ofwat's price control calibration and crucially the level at which the allowed return is set – as this is the primary driver of financial resilience.

Financial resilience should be a key consideration when calibrating the overall price control for PR24 and will be dependent on the level of risk exposure within the methodology and the pricing of this risk exposure.

In principle, we agree that company Boards should consider and provide assurance on financial resilience. However, the assessment is dependent on Ofwat's price control calibration and crucially the level at which the allowed return is set – as this is the primary driver of financial resilience.

Q9.3. Do you agree with our proposed approach to dividend policies, performance related executive pay and voluntary sharing of financial outperformance?

Strongly disagree

Key messages

- We are responding separately to the overall approach to financial resilience and ring fencing. Our responses to that consultation should be assumed to take precedence over this consultation as our work is ongoing. However, we discuss some areas below.
- We do not think it is necessary or appropriate to provide more prescriptive guidance as to which and when dividends should be paid.
- Additional requirements would duplicate our dividend policy and autonomy over the level and frequency of dividend payments attracts equity investment in the sector.
- Our remuneration policy for executive directors and senior managers takes into consideration the long-term performance of the business and is based on areas including Customer service delivery and business costs, environment performance, employee alignment and financial performance. The policy is reviewed regularly to take into account actual company performance in these areas.
- There is a high bar for the introduction of new regulation and any proposed new mechanisms would need to address a specific market failure. We have not identified a clear market failure which could be addressed through the introduction of a voluntary sharing mechanism.

We are responding separately to the overall approach to financial resilience and ring fencing. Our responses to that consultation should be assumed to take precedence over this consultation as our work is ongoing. However, we discuss some areas below.

Company performance is part of a suite of considerations within our dividend and executive pay policies. We do not think it is necessary to provide more prescriptive guidance on the level at which and when dividends should be paid. We do not set out additional proposals for voluntary sharing of outperformance.

Dividend policies

Our dividend policy sets out the factors taken into consideration by the Board for each dividend payment. These factors include current and projected performance, environmental performance, key credit metrics and expenditure requirements. This policy is broadly in line with Ofwat's proposals within the draft methodology.

We will comment further on the licence conditions in our response to the separate financial resilience consultation.

Executive pay

Our remuneration policy for executive directors and senior managers is based on four key focus areas:

- Customer service delivery and business costs
- Environment performance
- Employee alignment
- Financial performance

The policy takes into consideration long-term performance of the business so as not to incentivise short termism at the expense of longer term customer benefit. This policy is reviewed regularly to take into account actual company performance against the four areas detailed above. We do not think there is additional benefit in introducing more prescriptive guidance which would duplicate the considerations within our remuneration policy.

Voluntary sharing

There must be a high bar for the introduction of new regulation and any proposed new mechanisms would need to address a specific market failure. Neither you nor we have identified a clear market failure which could be addressed through the introduction of a voluntary sharing mechanism and do not propose any new mechanisms.

Chapter 10 - Companies' PR24 submissions

10.1 Are the PR24 submission requirements clear and sufficiently specified?

Disagree

Key messages

- It is hard to have a fully formed view on whether the requirements are clear and specified because there are still several documents to be issued over the coming months (guidance on DPC for example).
- We agree with the premise of board assurance, but believes the requirements are overly specific and take autonomy away from companies. Please see our further comments in response to question 10.4.
- We support Ofwat's desire to reduce the size of plan's submissions as commented on in question 10.3. However, there may be instances where large files of data are needed to support any proposals to changes in Ofwat's requirements that we believe should be excluded from this limit. These should be limited in number.
- We do not agree that redactions should be agreed with wider stakeholders – it should be down to our boards to decide what is appropriate to redact based on security and commerciality. Our redactions in PR19 were limited, and we would continue the principle of as open as possible. Adding further stakeholders into the process creates needless additional stages.
- We agree to the removal of the IAP stage if there was enough clarity in the draft methodology to understand what would be a compliant and expected plan. At the moment this clarity is not here, and so we feel the lack of IAP is a high risk for those submitting ambitious or alternative plans (e.g. an OBER focus). Please also see our comments on question 11.1.
- We would like to highlight the current uncertainty over the implementation of the single social tariff (SST). It feels increasingly unlikely that a tariff will be implemented by 1st April 2025, and indeed what level of certainty of tariff design we will have in time to incorporate this into our plans.
- We note Ofwat's comments on early data submissions and that these would be detailed in the final methodology. Any earlier sight of these would always be appreciated in order to alleviate the burden on companies when the 2023 APR is taking place.
- The guidance is particularly unclear regarding taking into account the impact of Covid-19 and the impact on the Per Capita Consumption performance commitment. We request further clarity on this.
- Section 4.2 of appendix 9 contains an inconsistency in that it states that Ofwat expects 'efficient companies will deliver their PCLs on average', and separately where targets are not achieved companies should be penalised.
- Very specific guidance is needed in relation to Per Capita Consumption. This is currently not clear and the final methodology needs to be clear on whether it is accepted that the 2024-25 PCL will not be met, how associated PR19 penalties will be addressed, whether Ofwat is planning to deal with PCC as a deviation and if so, how a revised PR24 year '0' PCL and future glidepath will be determined.

No, there are still several documents to be issued over the coming months (guidance on DPC for example) making it hard to have a fully formed view on whether the requirements are clear and specified.

We comment in more detail in question 10.4, but whilst we agree with the premise of board assurance, we believe the requirements are overly specific and take autonomy away from companies. We note that the document states it is for companies to determine assurance, but then ten pages of detail follows this statement which is counterintuitive.

We are supportive of Ofwat's desire to reduce the size of plan's submissions as commented on in 10.3. However, there may be instances where large files of data are needed to support any proposals to changes in Ofwat's requirements that we believe should be excluded from this limit. These should be limited in number.

We do not agree that redactions should be agreed with wider stakeholders – it should be down to our board to decide what is appropriate to redact based on security and commerciality. Our redactions in PR19 were limited, and we will continue with the principle of being as open as possible.

We also comment in question 11.1 about the removal of the IAP stage. We would be happy to see the IAP stage be removed if there was enough clarity in the draft methodology to understand what would be a compliant and expected plan. At the moment this clarity is not here, and so we feel the lack of IAP is a high risk for those submitting ambitious or alternative plans (e.g. an OBER focus).

We comment on the data tables in question 10.2, but overall would flag that these tables are significantly larger with more detail than for PR19 and are concerned about the implications these could have on future APRs, as well as the level of resourcing required to complete.

We would like to highlight the current uncertainty over the implementation of the single social tariff (SST). It feels increasingly unlikely that a tariff will be implemented by 1st April 2025, and indeed what level of certainty of tariff design we will have in time to incorporate into our plans in line with the following requirement:

Our current expectation is that each company should cover two scenarios in its business plan. First, it should be clear how its proposals would deliver on a legislative requirement to implement a single social tariff and its forecast impact. This should include how the company would assess the needs of and support customers currently in receipt of social tariffs who would not be eligible for support under a single social tariff scheme… Second, it should set out its proposals if a single social tariff is not in place for 1 April 2025. For this second scenario, we expect companies to provide forecast data based on their proposed social tariff offering in line with existing guidance and the current legal framework.

If detail on the design of the SST is not available by the time of the final methodology, we ask that Ofwat are explicit on what they would like us to model to ensure consistency across the industry, and ensure that your assessment of the quality of our plans is not impacted by a factor wholly outside of our control should we have to make assumptions on how it will be implemented.

We note Ofwat's comments on early data submissions and that these would be detailed in the final methodology. Any earlier sight of these would always be appreciated as the burden on companies when the 2023 APR is taking place and final assurance and review of business plans is not to be underestimated. Understanding what these additional requests are allows us to plan accordingly.

Ofwat's guidance is particularly unclear regarding taking into account the impact of Covid-19 and specifically the impact on the Per Capita Consumption performance commitment. In section 10.10.3 it says Ofwat has 'indicated that we many consider the impact' - this is not clear and we request further clarity on what Ofwat may consider and action as a result.

In Appendix 9, section 4.2 it states Ofwat expect 'efficient companies will deliver their PCLs on average', and separately where targets are not achieved companies should be penalised.

In Appendix 9 section 4.2 it describes how Ofwat would only consider deviating from the PR19 PCL when setting the 'year 0' position if there was sufficient and convincing evidence of material over or underperformance.' It also describes the evidence required to support a deviation.

Per Capita Consumption is a very specific example already recognised to be deviating from the expected performance. Ofwat needs to be very specific in your guidance about what is required / the approach you are taking. At present it is not clear whether it is accepted that the 2024-25 PCL will not be met, or how associated PR19 penalties will be addressed. It is not clear whether Ofwat are planning on dealing with PCC as a deviation and if so how a revised PR24 year '0' PCL and future glidepath will be determined. The final methodology needs to be clear on these points.

10.2 Is any data missing, or included but not required or areas we need to look at again?

Neither agree nor disagree – N/A

Key messages

- The tables are significantly larger than for PR19 and are concerned they may set a precent for future APRs which is not sustainable
- We request Ofwat consider the level of detail required across the tables and take a proportionate approach in the final tables published in the final methodology

We have made specific comments in the data tables response log. However, as a general comment we would like to flag that these tables are significantly larger than for PR19. Whilst we are supportive of several of the additions that are giving a place to articulate assumptions that were being made in models (for example in a number of the risk and return tables) we are concerned about the level of data being asked for elsewhere (for example, benefits valuations at driver level in the CW/CWW tables).

In particular, we do not believe these tables and the completion of them for PR24 should set a precedent for future APRs. The time, systems and resources to complete and assure these on a one-off basis for PR24, let alone if this level of detail were to be required on an annual basis for APRs, should not be under-estimated and detracts from the core delivery of our services.

The level of detail for forecasts required in some areas (e.g. in the developers services tables) also means that some of the data is likely to be almost meaningless due to the number of assumptions being made; we suggest that the intention of the data is reviewed and level of data requested reconsidered to ensure that the outcome sought can be achieved in a meaningful and useful way.

We therefore request that Ofwat reviews the level of detail being asked for across the tables and takes a proportionate approach when producing the final tables for publication in December. We have made some suggestions in the responses of areas where this could be done.

10.3 Are the limits on the number and size of documents workable? Should we be more prescriptive in terms of file and folder structures etc?

Agree

Key messages

- With some exceptions, we support the limit on file size and document numbers and that redactions should remain at the board's discretion. Further guidance on file and folder structure is not needed.
- We note that there may be instances where a significant amount of data may need to be provided - these should be considered separately to the business plan submission and should fall outside the final size limit.
- Although an open and transparent approach was taken in PR19, it was necessary to redact some areas due to security concerns or commerciality and we believe this should remain at the board's discretion.

We largely support, with minor exceptions, the limit on file size and document number, and do not believe you should provide further guidance on file and folder structure. We also believe that redactions should remain at our board’s discretion.

We understand and are supportive of Ofwat’s drive to make plans more focused and succinct and more easily accessible and better to navigate than PR19. Overall, we are supportive of limit on number of documents (80) and the file size proposed (25MB) for our plan. However, there may be isolated instances where we need to provide a significant amount of data (potential in excess of 25MB) if we are proposing an alternative to Ofwat’s stated assumptions. We believe these should be considered separately to the business plan submission and fall outside of the file size limit as a result.

We do not believe you should be more prescriptive in terms of file and folder structure, and that this should be at companies’ discretion in terms of how best they propose to set out their plan.

As commented on in our answer to question 10.1, we have concerns over the requirements on redaction; we believe at PR19 we had an open and transparent approach, but did need to redact some areas due to security concerns or commerciality. We believe this should remain at our board’s discretion and not require a further stage involving stakeholders, adding needless process.

10.4 Do our expectations for company board's assurance and governance arrangements provide enough guidance to ensure that boards have sufficient level of 'ownership' and so ensure a high quality submission?

Strongly disagree

Key messages

- Our view is that the assurance and governance arrangements go too far in that they are too prescriptive and take the autonomy away from companies and their boards.
- The Board fully embraces Ofwat's Board Leadership Transparency and Governance principles and the Wates Corporate Governance Principles for Large Private Companies. Wessex Water's Board is accountable for the accuracy and completeness of the information we report and publish. Board ownership is key to providing a strong assurance process. The five areas proposed for specific board assurance have guidance that is overly prescriptive, albeit the broad areas proposed are sensible.

Wessex Water's Board is accountable for the accuracy and completeness of the information we report and publish. Board ownership is key to providing a strong assurance process.

The Board fully embraces Ofwat's Board Leadership Transparency and Governance principles and the Wates Corporate Governance Principles for Large Private Companies.

To support the board assurance and governance arrangements for the business plan, we have established a PR24 Board Working Group and PR24 Executive Group.

The five areas proposed for specific board assurance have guidance that is overly prescriptive, albeit the broad areas proposed are sensible. Companies' boards should not be required to set out the steps they have taken to give the assurance required. There is no basis for this requirement and no benefit to customers or anyone else. As a well run company, it is for company boards to determine the processes they follow to enable them to be satisfied they have the assurance required. Ofwat's interference in this way in the running of the company is without foundation.

Our specific comments on the proposals for each area are set out below.

Long-term delivery strategies

> ***Proposed guidance***
> *The company Board should provide an assurance statement that explains how it has challenged and satisfied itself that the strategy:*
> - *reflects a long-term vision and ambition that is shared by the Board and company management*
> - *is high quality, and represents the best possible strategy to efficiently deliver its stated long-term objectives, given future uncertainties*
> - *is based on adaptive planning principles*
> - *has been informed by customer engagement*
> - *has taken steps to secure long-term affordability and fairness between current and future customers*
> - *will enable the company to meet its statutory and licence obligations, now and in the future.*
>
> *The Board should provide evidence of where it has challenged company management and an explanation of the process it has used to arrive at the view that its strategy is the best it can be. It is for companies and their Boards to determine how best to provide this assurance, including the role of external assurance. We will confirm our requirements for Board assurance more generally in the PR24 methodology.*

We agree with the elements proposed as in scope for the statement. But we do not think it is necessary for the board to explain the processes it has followed to enable it to make the statement. In our view:

(a) the requirement below should be removed:

The Board should provide evidence of where it has challenged company management and an explanation of the process it has used to arrive at the view that its strategy is the best it can be.

(b) The wording below should be changed as shown:

The company Board should provide an assurance statement ~~that explains how it has challenged and satisfied itself~~ that the strategy...

The guidance would therefore read:

The company Board should provide an assurance statement that the strategy:

- reflects a long-term vision and ambition that is shared by the Board and company management
- is high quality, and represents the best possible strategy to efficiently deliver its stated long-term objectives, given future uncertainties
- is based on adaptive planning principles
- has been informed by customer engagement
- has taken steps to secure long-term affordability and fairness between current and future customers

- will enable the company to meet its statutory and licence obligations, now and in the future.

We will also take this opportunity to comment that the contents of the long term delivery strategies will be hugely influenced by regulatory changes that we cannot forecast; for example, the nutrient neutrality changes currently being proposed would not have been forecast 20, or even 5, years ago. This must be taken into account when reviewing their accuracy in the future.

Affordability

> ***Proposed guidance***
> *That the board has challenged and satisfied itself that:*
> - *the full implication of the 2025-30 business plan for customers was considered and that the plan achieves value for money; and*
> - *the long-term delivery strategy protects customers' ability to pay their water bill over the long term and delivers fairness between what existing customers will pay and what is paid for by future customers*

We support the principles included in the statement. However:

(a) The ability of the board to give assurance that the plan achieves value for money and the protection of affordability for future customers will be compromised by the raft of legislative and regulatory requirements (current and future) being imposed on companies; and

(b) For the plan to protect customers' ability to pay their water bill over the long term and deliver fairness between existing and future customers, the approach to RCV run-off needs to be carefully considered. Please see our response to question 8.3 for more detail on this.

Costs and outcomes

> ***Proposed guidance***
> *That the board has challenged and satisfied itself that:*
> *A) The performance commitment levels in the plan are stretching but achievable and reflect performance improvements expected from both base and enhancement expenditure*
> *B) the plan includes price control deliverables covering the benefits of material enhancement expenditure (not covered by performance commitments)*
> *C) the expenditure forecasts included in the company's business plan are robust and efficient*
> *D) the options proposed within the business plan are the best option for customers and a proper appraisal of options has taken place*
> *E) the plan and the expenditure proposals within them are deliverable and that the company has put in place measures to ensure that they can be delivered*
> *F) that the expenditure proposals are affordable by customers and do not raise bills higher than necessary*
> *G) the expenditure proposals reflect customer views, and where appropriate are supported by customers*

We agree with the elements proposed for inclusion in the statement. Please see our responses to chapter 5 and 6 on cost assessment and outcomes for more detail.

Risk and return

> ***Proposed guidance** - **financeability***
> *That the board should:*
> - *provide assurance that the business plan is financeable and consistent with maintaining the target credit rating on the basis of the notional capital structure and provides sufficient headroom to a minimum investment grade credit rating under stress scenarios, taking account of mitigating actions. We expect companies to provide evidence of the steps taken by their board in giving that assurance*
> - *take account of all components of the business plan and set out clearly the steps taken to provide assurance, including the consideration of the financial ratios.*

We agree with the elements proposed as in scope for the statement. But we do not think it is necessary for the board to set out the steps taken to enable it to make the statement and/or provide evidence of these. The text highlighted below should be deleted:

Financeability

- provide assurance that the business plan is financeable and consistent with maintaining the target credit rating on the basis of the notional capital structure and provides sufficient headroom to a minimum investment grade credit rating under stress scenarios, taking account of mitigating actions. ~~We expect companies to provide evidence of the steps taken by their board in giving that assurance~~
- take account of all components of the business plan ~~and set out clearly the steps taken to provide assurance~~, including the consideration of the financial ratios.

Financial resilience

> ***Proposed guidance** - **financial resilience***
>
> *That the board should:*
> - *provide an assurance statement that the actual company is financially resilient over the period of the price review and beyond under its business plan*
> - *set out the steps it has taken to enable it to make that statement, the factors it has taken account of, and the suite of financial metrics used to ensure the*

We agree with the elements proposed as in scope for this. But we do not think it is necessary for the board to set out the steps taken to enable it to make the statement and/or provide evidence of these. The text highlighted below should be deleted:

- provide an assurance statement that the actual company is financially resilient over the period of the price review and beyond under its business plan

- ~~set out the steps it has taken to enable it to make that statement, the factors it has taken account of, and the suite of financial metrics used to ensure the company is financially resilient.~~

Overall, the guidance would therefore read:

That the board should:

- provide assurance that the business plan is financeable and consistent with maintaining the target credit rating on the basis of the notional capital structure and provides sufficient headroom to a minimum investment grade credit rating under stress scenarios, taking account of mitigating actions.
- take account of all components of the business plan, including the consideration of the financial ratios.
- provide an assurance statement that the actual company is financially resilient over the period of the price review and beyond under its business plan

Customer engagement

> ***Proposed guidance***
> *That the board should provide assurance that the company's customer engagement and research meets the standards for high-quality research and any other relevant statements of best practice and has been used to inform its business plan and long-term delivery strategy.*

We have no specific comments on the guidance in this area.

10.5 Do you agree with our proposal to continue to apply revenue adjustments for past performance across all years of 2025-30, after the financeability assessment?

Strongly agree

Key messages

- We agree with the proposal although with the additional bill smoothing flexibility, it is unclear why to distinguish the two.

Yes. Although with the additional bill smoothing flexibility it’s unclear why to distinguish the two.

Q10.6 Do you agree with our proposal for 2024-25 blind year adjustments? Should we treat in period ODI adjustments in the same way as other blind year adjustments or retina the approach set out in the Rulebook?

Strongly agree

Key messages

- We agree with the proposals for the blind year adjustments.
- For ODIs, we agree with the proposal for the added flexibility given to the blind year adjustment.

We agree with your proposals for the blind year adjustments.

For ODIs we agree with the proposal for the added flexibility given to the blind year adjustment.

10.7 Do you have any comments on how to best deal with the impact of shadow and non-shadow reporting in table BIO3 on other tables?

Neither agree nor disagree

Key messages

We will provide comments on this with our wider bioresources answers by the 16th September. However, we will not state whether we agree or disagree as this question is asking for comments.

10.8 Do you have any comments on the data we should collect in table BIO5?

Neither agree nor disagree

We will provide comments on this with our wider bioresources answers by the 16 September. However, we will not state whether we agree or disagree as this question is asking for comments.

Chapter 11 - Encouraging quality and ambitious business plans

11.1 Do you agree with the framework we propose to encourage the best business plans? Specifically, do you agree

- **that we should first assess 'quality' followed by 'ambition'?**
- **with our proposed allocation of rewards and penalties for performance on each?**

Strongly disagree

Key messages

- We are concerned about the lack of clarity around the definitions of quality and ambition. However, at the same time, the few examples that are given seem to be extraordinarily constraining.
- We agree that quality should be assessed first, before ambition but more clarity about the meaning of these terms is needed.
- Past performance should be included in an assessment of quality to avoid assuming an implausibly significant departure from historical performance.
- There appear to be contradictions within some of the proposed timelines e.g. the short turnaround for cost assessment and models that are planned for publication in Spring/Summer 2023 and the expectation that LTDS will use the ODI customer research values but these will not be published until December.
- It would be expected that rewards and penalties would be more prevalent in the regulatory framework that focuses on quality and ambition.
- We would be happy for the IAP stage to be removed provided that there was enough clarity in the draft methodology to understand what would be considered a compliant, quality and ambitions plan. Currently, this clarity is not present and the lack of an IAP is a high risk for those submitting truly ambitious or alternative plans.

We are concerned at the lack of clarity around the definitions of quality and ambition. However, at the same time, the few examples that are given seem to be extraordinarily constraining.

We agree that quality should be assessed first, before ambition. However, we need more clarity on the definition of ‘quality’ and ‘ambition’. This is unclear and will lead to uncertainty in business plan submissions as to whether companies can expect their plans to be seen as high quality and/or ambitious.

It is important that past performance should be assessed as well so that an assessment of quality doesn’t assume an implausibly significant departure from historical performance that fails to materialise in the future. This must be taken into account alongside a more traditional view of performance in terms of PCs and efficiency – this is still a critical factor in a company’s ability to deliver a plan, quality or otherwise.

More clarity is needed on ambition – the methodology states that PC targets will be set at ‘stretching but achievable’ levels. If we set targets at the upper quartile across the board, is this ambitious? Or are we expecting a step change? It should also include a view on long term delivery after 2030, but we recognise that this is harder to assess. Either way, deliverability should be considered as a critical aspect within an assessment of ambition.

For example, whilst there is more risk and reward proposed in the outcomes piece, it is unclear whether a company that provides a wider range of risk and reward than Ofwat proposes can still be high quality and high ambition, or whether it fail at the first gate because it hasn't "used Ofwat's assumptions". We believe this would be a shame as it would seem to stifle ambition if companies are required to mechanistically apply what Ofwat has proposed. As they stand, the incentives discourage innovation and encourage homogeneity. We believe guidance is required on this point significantly in advance of the final methodology so that companies can ensure the development of their plans meet expectations.

There also appear to be contradictions in the proposed timelines. For instance, cost assessment and models are planned to be published in Spring/Summer 2023, but Ofwat appears to be expecting huge amounts of governance and assurance on this area and we are concerned this will not be possible with such a short turnaround. The methodology also expects LTDS to use the ODI customer research values but these are not being published until December, by which time our LTDS will be well progressed to ensure it can form the central part of our business plan.

The rewards and penalties seem sensible for a traditional approach to business planning. In a world of quality and ambition though, we would expect to see both more prevalently in the regulatory framework.
In that world, it is likely that companies would be bearing significantly more risk and it would seem appropriate to reward that, including through the business plan incentives.

As discussed in response to question 10.1, we would be happy to see the IAP stage disappear if there was enough clarity in the draft methodology to understand what would be considered a compliant, quality, and ambitious plan. At the moment, this clarity is not here, and so we feel the lack of IAP is a high risk for those submitting truly ambitious or alternative plans.

11.2 Do you agree with the proposed scope of our 'quality' assessment? Specifically, do you agree:

- **we should have minimum expectations in the six areas described above?**
- **with the minimum expectations we specify in each of the six areas?**

Strongly disagree

Key messages

- We refer to our response to question 11.1 above.
- We would like to submit a high quality plan and for this to be based on the principles of OBER. However, it is not clear whether this would be seen as high-quality or not. The draft methodology does not give sufficient confidence to our board that they should bear that risk and we hope for and expect more clarity on this well in advance of the final methodology.
- The minimum expectations are severely limiting – particularly those around a "plan that uses our assumptions". We'd expect Ofwat to be considering a range of assumptions for different companies, rather than assuming a one-size-fits-all approach. It does not seem appropriate, ambitious, or high-quality for Ofwat to limit companies to a single approach or set of assumptions in all areas.
- We are concerned, after experience at PR19 that the bar for evidence to be compelling will be set subjectively and very rarely met. This could operate to bring all companies back into a one-size-fits-all approach on the basis that Ofwat does not find the evidence compelling.

We refer largely to our answer to 11.1. We would like to submit a high-quality plan. We would expect that plan to be focused on the principles of OBER but it is not clear whether that would be seen as high-quality or not. This lack of clarity essentially incentivises us to submit a plan that conforms with regulatory norms as we believe we could submit an excellent (albeit unambitious in the scheme of things) traditional plan. However, it would not – in essence – be the highest quality that it could be. Unfortunately, the draft methodology does not give sufficient confidence to our Board that they could bear that risk. We hope and expect more clarity well in advance of the final methodology.

The minimum expectations, in particular, are severely limiting – particularly those around a "plan that uses our assumptions". We'd expect Ofwat to be considering a range of assumptions for different companies, rather than assuming a one-size-fits-all approach. It does not seem appropriate, ambitious, or high-quality for Ofwat to limit companies to a single approach or set of assumptions in all areas.

We are also concerned, after experience at PR19, that the bar for evidence to be compelling will be set subjectively and very rarely met. Our fear is that this will be used as an excuse to bring all companies back into a one-size-fits-all approach on the basis that Ofwat does not find the evidence compelling.

We copy the expectations below for reference.

Table 3.1 Minimum expectations for PR24 business plans

Area	Minimum expectation	References
Data, information and assurance	The submission is accessible and, follows a clear structure, meeting our requirements as specified in our guidance.	Companies' PR24 submissions 10.3
	The company's long-term delivery strategy is fully consistent with the PR24 business plan. Across the PR24 submission, the company presents a single adaptive strategy, rather than multiple alternate plans.	Companies' PR24 submissions 10.4
	The company's full Board provides an assurance statement that meets our Board assurance requirements as specified in our guidance.	Companies' PR24 submissions 10.9
	The company provides the data and information as requested in our methodology and business plan tables. This data and information is consistent, accurate and assured using effective internal systems, controls and processes.	Companies' PR24 submissions 10.9
Long-term delivery strategy	The long-term delivery strategy has been developed in line with our guidance, including presenting future enhancement activities using adaptive pathways and testing against scenarios.	PR24 and beyond: Final guidance on long-term delivery strategies
Customer affordability and acceptability	The company's plan and long-term delivery strategy explain how it has taken account of views on overall affordability including those who struggle, or are at risk of struggling, to pay their bills. The company also explains how it will deliver fairness for both existing and future customers in relation to what they each pay for.	Reflecting an understanding of customers and communities 5.2; PR24 and beyond: Final guidance on long-term delivery strategies
	The company's plan and long-term delivery strategy provides sufficient and convincing evidence that it has used our standardised methodology for testing the affordability and acceptability of its business plan.	Reflecting an understanding of customers and communities 5.3

	The company's submission provides sufficient and convincing evidence that its customer engagement activities meet our standards for research, challenge and assurance.	Reflecting an understanding of customers and communities 5.3
	The company's business plan includes proposals for supporting customers to pay their bills using social tariffs and other methods. We expect the company to include proposals for the two scenarios we specify in our methodology.	Companies' PR24 submissions 10.8
Costs	The business plan sets out the benefits of the company's proposals, specifically: the performance levels delivered through base for all performance commitments; impacts of enhancement expenditure on performance commitments for 2025-30 and the longer term (i.e. to at least 2050); and the additional benefits of its proposals. Wherever appropriate it reflects these benefits in performance commitments and price control deliverables.	Setting expenditure allowances 6.4; 6.5; 6.6
	The business plan and long-term delivery strategy are consistent with the achievement of government targets and statutory requirements. In Wales this includes demonstrating how companies have taken into account the outputs of the collaborative approach.	Setting expenditure allowances 6.5; Companies' PR24 submissions 10.4
	The business plan and long-term delivery strategy include investment options which are consistent with the company's finalised water resources management plan, final WINEP/NEP submission and, if applicable, drainage and wastewater management plan, having adequately addressed any feedback previously provided on these. We also expect compelling evidence on the need for variations from final plans, if relevant.	Setting expenditure allowances 6.5; Design and implementation of price controls 3.3
	The company proposes to use direct procurement for customers (DPC) to deliver eligible schemes.	Design and implementation of price controls 3.9
Outcomes	For common PCs the company's plan contain incentive rates that we propose based on marginal benefit estimates from the collaborative customer research and indicative benefit sharing factors. Where a company provides a different view, it provides compelling evidence, consistent with any relevant guidance.	Delivering outcomes for customers 5.4
	If the company's business plan includes bespoke performance commitments, the company sufficiently demonstrates how it has responded to any feedback we have provided on its definition, or any new proposals meet the expectations we have set out in the methodology. For incentive rates for bespoke performance commitments, the company demonstrates how its proposals are consistent with our draft methodology and any relevant guidance.	Delivering outcomes for customers 5.2
Risk and return	The business plan uses our early view of the allowed return on capital or provides compelling evidence that another rate is more appropriate.	Aligning risk and return 7.3
	The company's submission provides sufficient and convincing evidence that the overall business plan provides an appropriate balance of risk and return.	Aligning risk and return 7.2
	If the company's business plan includes bespoke uncertainty mechanisms and notified items then these meet the expectations we have set out in our methodology.	Aligning risk and return 7.2

	The company's Board provides assurance that its business plan is financeable on the basis of the notional structure and this is supported by sufficient and convincing evidence of the steps taken to provide this assurance.	Financeability 8.1; 8.4; 8.5
	The business plan uses appropriate cost recovery rates and provides sufficient and convincing evidence for any adjustments to underlying PAYG and RCV run-off rates.	Financeability 8.2
	The company's Board has provided assurance that it will maintain financial resilience during 2025-30 and in the long-term, taking account of its business plan under its financing and capital structure. We expect also this is supported by sufficient and convincing evidence of the steps taken to provide this assurance and of the steps to improve financial resilience where necessary.	Promoting financial resilience 9.2; 9.3
	The business plan sets out the company's dividend policy for 2025-30 and the policy is in line with our guidance.	Promoting financial resilience 9.5
	The business plan sets out the company's policy for performance related executive pay during 2025-30 and the policy is in line with our guidance and Board leadership, transparency and governance principles.	Promoting financial resilience 9.6

11.3 Do you agree with the proposed scope of our ambition assessment?

Strongly disagree

Key messages

- Our view is that a key element has been omitted from the scope of Ofwat's ambition assessment in that companies with very ambitious plans e.g. to maximise the use of outcome-based regulation, are likely to be taking more risk. There should be an associated reward for that risk and we would suggest that some of this could be appropriated through the business plan incentives.
- We encourage Ofwat to consider a differential category for both quality and ambition that incentivises a non-traditional plan for those companies that truly want to go beyond the minimum requirements. This would recognise the additional risk of both submitting such a plan, as well as the risk associated with delivering it. It would do so by creating incentives throughout the price review process.
- Please refer to our response in relation to question 11.1 above.

We refer to our answer to 11.1. We believe that a key element of ambition is missing. This is the fact that companies with very ambitious plans, i.e. to maximise the use of outcome based regulation, are likely to be taking more risk. There should be an associated reward for that risk and we would suggest that some of this could be appropriated through the business plan incentives.

We would encourage Ofwat to consider a differential category for both quality and ambition that incentivises a non-traditional plan for those companies that truly want to go beyond the minimum requirements. This would recognise the additional risk of both submitting such a plan, as well as the risk associated with delivering it. It would do so by creating incentives throughout the price review process.

11.4 Do [you] agree with our proposed reputational, financial and procedural rewards and penalties, including the overall package of reward and penalty?

Strongly disagree

Key messages

- We believe that incentives could be significantly stronger in encouraging an outcomes-based plan that delivers genuine efficiency in delivery of outcomes for customers, society, and the environment. Please refer to our response in relation to question 11.3 above.

As discussed in question 11.3, we believe the incentives could be significantly stronger in encouraging an outcomes-based plan that delivers genuine efficiency in delivery of outcomes for customers, society, and the environment.

11.5 Do you have any other comments regarding our proposed approach to business plan incentives at PR24?

We have no further comments.

Appendix 6 - Performance Commitments

6.1 Do you have further views on whether the proposals laid out for C-MeX are appropriate?

Neither agree nor disagree

Key messages

- We welcome the retention of C-Mex at PR24 and comments on the following areas on the proposed amendments:
    - We prefer to retain the check and challenge process because there is still a need for this because the challenge process is still in use. If check and challenge is removed, we would require more assurance and visibility of the quality checks in place at Accent and improvements being made.
    - We appreciate the difficulty in meeting quotas for the CESs and are comfortable with the use of alternative approaches although some adjustment may be needed. We note that if incentives are offered, this will increase the cost of the survey.
    - On communication channels, our view is that if the minimum requirement is increased, we would need early sight and discussion around the communication channels to be included to give time to implement. We must ensure that C-MeX is not incentivising companies to add channels that customers don't want.
    - We are concerned about the proposed timing for finalising the design of C-MeX. We believe this should be published in the Final Methodology so companies can factor any implications into their Business Plans.
    - We are supportive of the intention to increase the size of C-Mex as it provides an important measure of customer experience and we refer to our response to question 5.4.
    - We would like postcodes, even if truncated, to be included in the data set so we can evaluate if local/community initiatives are having an impact. This will make it easier to use the outputs of CES by providing a link between the survey response and geographical area.
    - We believe the CES element of C-MeX should be removed; it is providing perverse incentives by driving companies to spend money on marketing and building awareness rather than fundamental improvements to service. This is reflected in the scores, where there are companies who perform well on CES but perform poorly on customer service. Unless improvements in CES can demonstrably lead to improvements in customer service scores, it is inappropriate to incentivise expenditure for no service improvement.
    - If CES is retained, we argue that it needs to be refreshed because the responses suggest customers are not understanding the key satisfaction question and answering about their water supply as opposed to water services as a whole.

We welcome the retention of C-MeX at PR24. We have the following comments on the proposed amendments:

Check and challenge

We would prefer to retain the check and challenge process. We appreciate it is designed to check the accuracy of the survey record and this has improved over time, but we are still making successful challenges of this nature. For example, since April 2020 we have had eight successful challenges relating to call quality including:

- Interviewer prompting the customer to give a score of 5 when the customer stated that they did not wish to provide a score.
- Three occasions where the interviewer prompted the customer to give a reduced score or lead the customer towards giving a particular score.
- Customer misunderstanding the scoring scale. Accent confirmed that the interviewer should have gone back over the score with the customer and reviewed this further.
- Interviewer not guiding the customer away from discussing a previous incident relating to a private issue (non-appointed activity).
- Call recording suggesting that the customer was driving at the time. Accent agreed to remove this survey and advised that this should be checked with the customer before conducting the survey.
- Needs and wishes of the customer (complete the survey at another time) not being listened to by the interviewer, who went ahead with the survey at an inappropriate time.

We are consistently the best performing WaSC on C-MeX and margins are very tight on the comparative league tables. Any erroneous score can make a difference to our ranking. We appreciate this proposal may also be due to the increase in digital contact for some companies and the difficulties around check and challenge with an online survey. We understand that Water UK's Customer Service Network have put forward ideas of how a check and challenge process could be implemented for digital surveys. Equally those companies have made an active decision to push digital interaction. We have chosen to invest heavily in a warm and fast telephone service to meet our customers' expectations and shouldn't be penalised for that.

If check and challenge is removed, we would need to have more assurance and visibility of the quality checks in place at Accent and improvements being made.

Customer experience survey

We believe the CES element of C-MeX should be removed; it is providing perverse incentives by driving companies to spend money on marketing and building awareness rather than fundamental improvements to service. This is reflected in the scores, where there are companies who perform well on CES but perform poorly on customer service. Unless improvements in CES can demonstrably lead to improvements in customer service scores, it is inappropriate to incentivise expenditure for no service improvement.

Alternative surveying approaches

We appreciate the difficulty meeting quotas for the CESs and are comfortable with the use of alternative approaches. If, for example more online panels are used, there would potentially need to be a correction factor applied to those survey responses in the same way as CSS and Ofwat will need to ensure the same proportion of online surveys are completed for each company as scores tend to be lower.

If incentives are offered this will increase the cost of the survey.

Communication channels
If the minimum requirement is increased, we would need early sight and discussion around the communication channels to be included to give time to implement. We must ensure that C-MeX is not incentivising companies to add channels that customers don't want.

Other suggestions
Water companies find it very difficult to use the outputs of the CES as there is no information provided to link the survey response to a geographical area. We would like postcodes, even if truncated, to be included in the data set so we can evaluate if local/community initiatives are having an impact.

We also believe the CES needs to be refreshed as the responses suggest customers are not understanding the key satisfaction question and answering about their water supply as opposed to water services as a whole.

Timing
We are concerned about the proposed timing for finalising the design of C-MeX. We believe this should be published in the Final Methodology so companies can factor any implications into their Business Plans.

As per question 5.4, we are supportive of the intention to increase the size of C-MeX as it provides an important measure of customer experience

6.2 Do you agree that C-MeX needs to adapt to provide better service to vulnerable and worst served customers?

Strongly disagree

Key messages

- Companies should be offering a fully inclusive and accessible service to all customers and every customer, regardless of their needs, should have an excellent experience.
- Our view is that C-MeX should remain a general measure of customer experience. It is already complex and to try and incorporate these other areas would only increase that complexity.
- Improved service for vulnerable and worst served customers should be driven by other incentives or mechanisms which could include:
    - Proposed customer licence condition
    - Achievement of the British Standard for Inclusive Service Provision BS18477 (soon to be replaced by ISO 22458)
    - Implementation of all recommendations of CCW's affordability review
    - Delivery of company complaint action plans
    - Compliance with best practice and broader policy guidance
    - Wider best practice sharing.

Companies should be offering a fully inclusive and accessible service to all customers and every customer, regardless of their needs, should have an excellent experience.

We believe that C-MeX should remain a general measure of customer experience. It is already complex and to try and incorporate these other areas would only increase that complexity.

Improved service for vulnerable and worst served customers should be driven by other incentives or mechanisms which could include:

- Proposed customer licence condition
- Achievement of the British Standard for Inclusive Service Provision BS18477 (soon to be replaced by ISO 22458)
- Implementation of all recommendations of CCW's affordability review
- Delivery of company complaint action plans
- Compliance with best practice and broader policy guidance
- Wider best practice sharing.

6.3 What are your views on our proposal to introduce a single, combined common performance commitment ('BR-MeX') capturing the experience of both end business customers and retailers as intermediate customers?

Neither agree nor disagree

Key messages

- We have reservations about the measures being suggested and whether they will provide a truly accurate assessment of that performance but we agree in principle that wholesale performance should be measured.
- Our view is that both R-Mex and B-Mex are important measures but because they highlight subjective measures, they should be combined with a third, more objective performance measure which captures underlying performance such as the existing OPS. This would align it with the approach taken for D-Mex.
- We make the following comments and suggestions for improvements.
    - R-Mex: Our primary concern is that R-Mex is heavily influenced by a retailer's perception of wholesale performance rather than the actual strength of underlying performance and that there are several other factors that could inappropriately influence scores.
    - B-Mex: Our primary concern is whether when being surveyed, a customer can differentiate between the retail and wholesale functions and between supply and waste side providers for those who sit within a WOC area. Customers may also be influenced in their responses by a poor relationship with their retailer. This can be addressed through the approach of the surveying entity and in distinguishing between experiences related to the wholesaler and those that relate to the retailer. This should in theory be a C-Mex type assessment which we would support.

We have reservations as to the measures being suggested and whether they will provide a truly accurate assessment of wholesaler performance but we agree in principle that wholesale performance should be measured. We make the following comments and suggestions for improvements.

R-MeX

R-Mex is a measure that has been in operation for the last two years. Our primary concern is that R-Mex is heavily influenced by a retailer's perception of wholesale performance, rather than the actual strength of underlying performance. Wholesaler's positions in the R-Mex league tables do not necessarily reflect their position in the Operational Performance Standards (OPS) table, a measure of tasks completed within their agreed operational target. This highlights the subjective nature of the survey, which is further supported by our position in the three surveys to date; we were joint top of the first, in the lower portion of the second and middle of the pack in the third.

There is also no weighting in the measure; a retailer with 90% of a wholesaler's SPIDs has the same scoring influence as a retailer with just 1% of the SPIDS .

We also believe that retailers are not fully engaged in the current R-Mex survey. They are either not completing the survey or providing neutral scores if there has been little interaction with the wholesaler (or indeed, to quote one retailer 'we just give everyone a 5').

B-Mex
This measure has not been introduced and detail on its methodology is limited so we are unable to make specific comments. However, our immediate concern is whether a customer can differentiate between the retail and wholesale functions when being surveyed, and indeed between supply and waste side providers for those who sit within a WOC supply area.

Customers when responding to the survey may be influenced by a poor relationship with their retailer. The key will be the approach of the surveying entity, ensuring the customer is only being questioned on wholesale activities or that they are skilled enough to determine whether the customers experience is the creation of the wholesaler or retailer. This should in theory then be a C-Mex type assessment which we could support.

For example, take the situation of a disconnection. A retailer may request a disconnection that the wholesaler has to action, but regardless of the experience of the disconnection itself, a business may have a negative perception of the whole experience.

In summary, whilst both R-Mex and B-Mex are important measures, they are highly subjective. We take the view that they should be combined with a third more objective performance measure which captures underlying performance such as the existing OPS. This would align it with the approach taken for D-MEX.

6.4 Do you consider evidence suggests that the current water supply interruptions performance commitment is inhibiting innovation? If so please provide it.

Strongly agree

Key messages

- Our view is that the current performance commitment definition continues to disincentivise best value to customers. If this definition continues, we are unlikely to champion further innovation in no-dig technology because it will have a material negative impact on our performance.
    - Before the stretching PR19 performance commitment on supply interruptions, we achieved 80% of repairs using no-dig technology. This has reduced to 45% to enable us to meet the supply interruptions target.
- We note that innovative no-dig technology provides best value to customers for planned outages because it typically has less impact on the environment, reduces the need for and duration of traffic management/road closures and has less overall cost. However, it can often negatively impact the supply interruptions performance commitment.

Innovative no-dig technology provides best value to customers for planned outages as it typically has less impact to the environment, reduces need and duration of traffic management/road closures and has less overall cost. However, it can often impact the supply interruptions performance commitments as customers could be out of supply for over three hours which in the same scenario, would not be the case where a trench is dug. This is because a trench can be dug whilst the existing pipe still supplies water, whereas no-dig technologies requires the deployment of a separate temporary water supply.

Whilst conventional trench approaches can reduce the time that customers are out of supply compared to innovative no-dig technology, it can have a greater impact on:

- Customers' bills (approximately 25-33% increase on mains replacement unit rate)
- Recreational use as gardens, parks etc could be out of use when a new trench is dug
- Economic value due to the impact of traffic management/road closures on local businesses
- Societal value due to the increase of commuting on individuals from traffic management/road closures
- The wider environment through increased use of carbon and the disruption to biodiversity when "dug up"

Due to the nature of the above work, reducing leaking and increasing the maintenance of our network will either cost more and create additional disbenefit to customers and the environment or, reduce our supply interruptions performance in the short and medium term.

Before the stretching PR19 performance commitment on supply interruptions, we achieved 80% of repairs using no-dig technology. This has reduced to 45% to enable us to meet the supply interruptions target.

If the current performance commitment definition continues to disincentive best value to customers, then we are unlikely to champion further innovation in no-dig technology as it will have a material impact on our performance.

6.5 Do you agree with our proposed definition for the biodiversity performance commitment?

Agree

Key messages

- We agree with the need for a biodiversity performance commitment which reflects the need to enable nature's recovery and with the approach set out by this performance commitment. However, we have some reservations and requires clarification in some areas, and makes the following comments:
    - the Defra Biodiversity Metric 3.0 is the most appropriate current tool to use for assessment purposes but it should be recognised that this tool is evolving and will change and improve over the course of PR24.
    - we recommend a five-year assessment period, once per AMP, rather than every four years. This is because only small changes, which may not be possible to significantly demonstrate or quantify, would be recorded in a four-year period. However, we recognise the need to report change in each AMP period and so suggest a 5-year assessment period to enable this.
    - there is currently limited detail on how water companies' efforts with third parties, such as landowners and charities, will contribute towards the metric to be used for this PC (e.g. biodiversity units per hectare of land owned by the company – when clearly this land is in third party ownership). Further clarity is required on this.

We agree with the need for a biodiversity performance commitment which reflects the need to enable nature's recovery. We agree with the approach set out by this performance commitment but do have reservations and require clarification in some areas.

It is acknowledged that this needs to be a long term commitment recognising the time it takes for biological systems to respond and recover where newly created or actively managed. The methodology acknowledges that measurable biodiversity improvements will not be achieved until post 2030 following baseline surveys, changes to management practices and re-assessment in the later years of AMP8.

The Defra Biodiversity Metric 3.0 is the most appropriate current tool to use for assessment purposes but it should be recognised that this tool is evolving and will change and improve over the course of PR24.

We would recommend a five-year assessment period, once per AMP, rather than every four years. This acknowledges the timescales for meaningful biodiversity change highlighted in the Defra Biodiversity Metric guidance, where, for example, it may take 30 years for appreciable change to be recorded in woodlands or 10 years for grassland habitats. Only small changes, which may not be possible to significantly demonstrate or quantify, would be recorded in a four-year period. However, we recognise the need to report change in each AMP period and so suggest a 5-year assessment period to enable this.

It is helpful that Ofwat has recognised that water company efforts with third parties, such as landowners and charities, can contribute towards this PC. This is particularly important for smaller companies with more limited landholdings but extensive catchment management and partnership programmes delivering meaningful biodiversity improvements. However, there is limited detail on how this will contribute towards the metric to be used – biodiversity

units per hectare of land owned by the company – when clearly this land is in third party ownership. Further clarity is required on this.

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

Agree

Key messages

- We agree that there should be separate measures for water and wastewater, which are based on a normalised measure. However, clarification is needed in relation to:
    - the definition for scope 3 emissions
    - sector-wide agreement is needed for WASCs for either conversion factors or retention of an option to recalibrate base year emissions.
- We agree that there is a need for absolute emissions reporting alongside as stipulated on page 67 of Appendix 7 – Performance commitment definitions
- Offsetting must included as part of the suite of measures to meet net zero.

We support the overall approach being proposed for greenhouse gas emissions, i.e. We agree that there should be separate measures for water and wastewater, which are based on a normalised measure.

However, more clarification is needed on the following:

- The definition for scope 3 emissions needs to be much more precise. At the moment it could be misconstrued as including a lot of embodied carbon emissions which Ofwat does not propose to be included. Instead we'd propose that
    - Ofwat refers to the GHG Protocol categories to specify what is included
    - The scope 3 operational emissions boundary only includes the items that that are already in the sector's carbon accounting workbook i.e. contractor emissions, public transport, electricity distribution losses.

- For WASCs, there is a risk that reported nitrous oxide emissions will need to be revised upwards significantly as knowledge increases on the back of monitoring trials. This further increases the need for separate water and wastewater performance commitments. Consequently, we will need sector-wide agreement for WASCs that either
    - fixed conversion factors are used throughout the period for converting incoming nitrogen load to emitted nitrous oxide - and does not change during the period even if new knowledge emerges, or
    - an option is retained to recalibrate base year emissions.

Normalising emissions

Normalised emissions offer comparison between companies, although it is somewhat superficial.

Firstly, geography is important e.g. some companies have inherent advantages and disadvantages regarding pumping energy due to topography.

Secondly, year to year numbers can be somewhat noisy due to the weather, as it changes the denominator in the equation. E.g. a dry year will reduce the volume denominator in the wastewater CO2e / Ml equation and make it look as if 'performance' has worsened.
For these reasons we agree on the need for absolute emissions reporting alongside as stipulated on page 67 of Appendix 7 – Performance commitment definitions.

Offsetting

We note that your clarification questions state that offsetting will not be included within the calculations for this performance commitment. We fundamentally disagree; offsetting must be considered as part of a suite of measure to reach net zero. It may be that market prices are, at a certain point, the best value approach to reduce emissions for a period of time. This means that offsets from green solutions we deliver ourselves, as well as through third parties (be that catchment management as part of a phosphorus reduction programme, or a specific contract to offset carbon) must be considered. To not do so would create the perverse incentive of having to choose between not reducing greenhouse gas emissions further (through efficient offsets) or taking less efficient approaches to greenhouse gas emission reductions at the expense of customers.

6.7 Do you agree with our proposal that the performance commitment on serious pollution incidents should only apply to water and wastewater companies?

Strongly disagree

Key messages

- We disagree with this proposal because it is fundamentally unfair to give one company an underperformance payment and not another for the same environmental impact. This is not in the best interests of customers.
- We also disagree with the premise of this underperformance only performance commitment because each company already receives a direct financial impact from prosecutions when a serious pollution incident occurs. We propose that this measure is removed to prevent companies being penalised twice, if not a third time through the performance commitment, Total Pollution Incidents.
- If this performance commitment remains, we propose that it is applicable to water only companies as well.

We disagree with this proposal as it is fundamentally unfair to give one company an underperformance payment and not another for the same environmental impact. This is not in the best interests of customers.

However, we also fundamentally disagree with the premise of this underperformance only performance commitment as each company already receives a direct financial impact from prosecutions when a serious pollution incident occurs. We propose that this measure is removed to prevent companies being penalised twice, if not a third time through the performance commitment Total Pollution Incidents.

If this performance commitment remains, we propose that it is applicable to water only companies as well.

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

Strongly disagree

Key messages

- We do not agree that Bathing Water status is a good or fair Performance Commitment for water companies due to the many locations where standards are influenced by other parties.
- Bathing Water status is not a good measure for a reduction in public health risk because it provides no real-time indication of water quality to enable customers to consider water quality issues in their decision making. We are proposing to address this through its real-time bacteriological monitoring using AI tools successfully developed for Warleigh Weir near Bath. We are proposing to roll this out to popular bathing locations around the Wessex Water area as part of our AMP7 outputs.
- We do not consider that any of the three options presented in the draft methodology are sensible nor fair Performance Commitments.
- By holding water companies to account for Bathing Water status, this perpetuates the incorrect information that the only sources of bacteriological pollution in rivers and sea are from water company assets.

As Ofwat notes *"We also recognise that other parties can sometimes impact bathing waters"* Consequently, we do not agree that Bathing Water status is a good or fair performance commitment for water companies due to the many locations where standards are influenced by other parties.

There are many existing coastal bathing waters where water companies either have no assets or their assets have been proven to have no impact on the current bathing water status due to over-riding other pressures, e.g. Weston super Mare (influence of birds as demonstrated by EA's Microbial Source Tracking analysis), Burnham Jetty North (where £31m of investment to reduce the bacterial load from water company assets by >50% has had no impact on sampling data or bathing water status due to the ongoing influence of bacteriological loads from agriculture) or Kimmeridge (where the only assets that affect the bathing water do not belong to a water company).

Some bathing water locations are naturally influenced more by other sources. An example of this can been seen by considering the data between the South coast of Wessex Water's area, where beaches are generally Excellent and the North coast of Wessex Water's area, where beaches consistently don't meet Excellent standard. The significant underlying difference is due to the influence of the River Severn on the northern coast beaches (see table below).

Wessex South Coast Beach Name	2021 Classification
Christchurch Highcliffe Castle	Excellent
Christchurch Friar's Cliff	Excellent
Christchurch Avon Beach	Excellent
Christchurch Mudeford Sandbank East	Excellent

Bournemouth Hengistbury West	Excellent
Bournemouth Southbourne	Excellent
Bournemouth Fisherman's Walk	Excellent
Bournemouth Manor Steps	Excellent
Bournemouth Boscombe Pier	Excellent
Bournemouth Pier	Excellent
Bournemouth Durley Chine	Excellent
Bournemouth Alum Chine	Excellent
Poole Branksome Chine	Excellent
Poole Canford Cliffs Chine	Excellent
Poole Shore Rd Beach	Excellent
Poole Sandbanks Peninsula	Excellent
Poole Harbour Lake	Excellent
Poole Rockley Sands	Good
Shell Bay North	Excellent
Studland Knoll House	Excellent
Swanage Central	Excellent
Kimmeridge Bay	Excellent
Lulworth Cove	Excellent
Durdle Door East	Excellent
Durdle Door West	Excellent
Ringstead Bay	Excellent
Bowleaze Cove	Good
Church Ope Cove	Excellent
Weymouth Lodmoor	Excellent
Weymouth Central	Excellent
Portland Harbour Castle Cove	Excellent
Portland Harbour Sandsfoot Castle	Good
Hive	Excellent
West Bay (West)	Excellent
Eypemouth	Excellent
Seatown	Excellent
Charmouth West	Excellent

Wessex North Coast Beach Name	**2021 Classification**
Porlock Weir	Excellent
Minehead Terminus	Good
Dunster North West	Sufficient
Blue Anchor West	Sufficient
Burnham Jetty	De-designated
Berrow North of Unity Farm	Good
Brean	Good
Weston-super-Mare Uphill	Sufficient
Weston Main	Poor
Weston-super-Mare Sand bay	Sufficient
Clevedon Beach	Good
Henleaze Lake	Good

Consequently, we do not consider any of the three options presented in the draft methodology are sensible or fair performance commitments.

The outcome desired is a reduction in public health risk.

Bathing Water status is not a good measure for this as it provides no real-time indication of water quality to enable customers to consider water quality issues in their decision making. This is an area where we are proposing to address through our real-time bacteriological monitoring using AI tools successfully developed for Warleigh Weir near Bath. We are proposing to roll this out to popular bathing locations around the Wessex Water area as part of our AMP7 outputs.

Note that ‘Excellent’ Bathing Water status does not mean that public health risk is eliminated. The WHO standards for ‘Excellent’ estimate that there is still a 10% chance of illness for people using such Bathing Waters.

Holding water companies to account for Bathing Water status perpetuates the incorrect information that the only sources of bacteriological pollution in rivers and sea are from water company assets.

6.9 Do you agree with our proposal for the river water quality performance commitment to measure the reduction of phosphorus entering rivers?

Agree

Key messages

- We agree with an outcomes-based approach to delivering improved water quality and its intention to include asset, catchment management and nature-based solutions enabling phosphorus reductions. However, the preferred approach must include the opportunity to reduce phosphorus contributions to watercourses from water company application or incentivisation of nature-based solutions and catchment management with third parties on a catchment scale. (We note that this is set out in this way in 4.7.1 but that 4.7.2 states “loads discharged from wastewater treatment works (our preferred option”)

We support this outcomes-based approach to delivering improved river water quality and its intention to include asset, catchment management and nature-based solutions enabling phosphorus reductions. However, 4.7.2 contradicts 4.7.1 in that it states the preferred approach is to include just treatment works, rather than catchment and nature based solutions – “*loads discharged from wastewater treatment works (our preferred option)”.* It is critical that the definition includes the opportunity to reduce phosphorus contributions to watercourses from water company application or incentivisation of nature-based solutions and catchment management with third parties, on a catchment scale.

PR24 guidance and Government direction, such as the Regeneration and Levelling Up Bill and proposed Environment Act targets, are severely limiting opportunities to deliver catchment and nature-based solutions by focussing on assets either through the introduction of Technically Achievable Limits to ‘achieve’ nutrient neutrality or 80% reduction of phosphorus load discharged from water recycling centres.

Our current Catchment Nutrient Balancing approaches in the Tone and Parrett, Somerset, and Dorset Stour catchments are delivering phosphorus reductions through a combination of new asset provision, optimising existing assets and catchment management to achieve WFD fairshare targets. However, these multi-beneficial and sustainable approaches would be prohibited under the recently consulted upon Environment Act targets.

In addition, we have a good track record in delivering environmental improvements through catchment and nature-based solutions through existing performance commitments, for example in the Poole Harbour catchment we have worked with farmers to reduce between 40 to 70 tonnes per year of nitrogen being leached into groundwaters since 2020, incrementally increasing the reduction each year. This ‘offset’ far exceeds the load reduced from the asset solution, which achieves c.9 tonnes per year reduction at significant carbon and financial cost.

Appendix 13 - Data and modelling

We have not reviewed the proposed financial model in detail. We believe there are substantial changes, specifically around bioresources still to come and so have no specific comments on it at this time.

13.1 Do you agree with our proposed approach to mechanisms at PR24?

Agree

Key messages

- We agree with the overall direction of simplifying the reconciliation process. Specifically, the proposed removal of a number of mechanisms. We think those mechanisms under consideration should ultimately also be removed.

We agree with the overall direction of simplifying the reconciliation process. Specifically, the proposed removal of a number of mechanisms. We think those mechanisms under consideration should ultimately also be removed.

The overall suite of mechanisms has been growing in scope and complexity for a number of price controls, and we welcome the review of it here.

We agree with your proposal to remove the bilateral market entry mechanism and the RPI / CPIH wedge reconciliation. We also welcome the consideration of the DSRA, WINEP and GOSM and we ultimately think that these should also be removed.

With your proposal to move the majority of developer services activity outside of the price control we can see no reason to retain the DSRA. Without this level of activity impacting totex reconciliation or the revenue cap there is no need for this mechanism. As we discuss elsewhere, we believe totex sharing is sufficient to cover the residual risk around network reinforcement.

We believe there was never a case for the introduction of the GOSM, a view echoed by the CMA at the PR19 redeterminations. Companies' actual financial structures are purely the domain of the companies' Board. We are fully supportive of its removal.

Ideally, we agree that there is no need for a WINEP reconciliation if there is sufficient certainty around requirements. However, if there is no such certainty then there may be a case for the inclusion of such a reconciliation mechanism as totex sharing would not be sufficient.

We can see the case for retaining the proposed mechanisms. Although there are some details that we may not fully agree with such as the calibration of the ODI incentive package and the cost of new debt reconciliation, these are discussed elsewhere in our response.

We note that PCDs are not discussed here, and that they could potentially add in significantly more complexity to reconciliation. Again we discuss our thoughts on them in our commentary on appendix 9, included in our chapter 6 answers.