Anglian Water's response to Ofwat's PR24 and beyond discussion document

July 2021

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PR24 and Beyond: Creating tomorrow, together

Executive Summary

Alignment on the need for a long-term focus

(1) Overall, we very much welcome the broad direction signalled in the PR24 discussion document, which highlights a number of long-term priorities that we agree are critical to the interests of customers and the environment. The East of England faces acute challenges from water stress, flood risk and population and housing growth. This means that making real progress on these priorities in PR24, and setting the right platform for the period beyond, is of particular importance in this region.

(2) However, there are a number of areas where we believe more radical changes from the baseline of PR19 are needed if the priorities highlighted are to be realised. There are also some other factors not raised in the document which we suggest be considered in the next phase of Ofwat's thinking.

Delivering against the long-term goals

(3) Placing PR24 in the longer-term context with a focus on addressing the challenges facing the sector and driving greater environmental and social value is essential, as the discussion document makes clear. We see clear synergies here with our stated company Purpose "to bring environmental and social prosperity to the region we serve through our commitment to Love Every Drop".

(4) The emphasis on the long term and how 5-year business plans should be stepping stones toward the achievement of delivering long term outcomes for customers and the environment fully accords with the approach we have maintained over the last 15 years. We first published our Strategic Direction Statement (SDS) in 2007, and then refreshed it in 2017 after extensive collaboration and consultation with our customers and stakeholders. The SDS sets out our four long term ambitions in response to the challenges facing our region. Our SDS formed the backdrop for our PR19 business plan and will do so again for PR24. Ofwat's *PR24 and beyond* document essentially suggests all companies adopt a similar approach for PR24. We believe this is a sensible approach given the scale of challenges the country as a whole faces.

(5) We welcome the shift in emphasis for companies to consider greater integration and alignment of long term strategic planning frameworks such as WRMP, DWMP and WINEP. This is in line with changes we have made within our organisation to enable a greater focus on this, to ensure we develop these plans in ways that realises potential synergies between them. Given the range of investment pressures facing the sector, and the need to ensure that we can deliver these whilst minimising pressure on customer bills, it is ever more important to leave no stone unturned in ensuring alignment between our long term plans. This also fits with the work the sector is doing in setting its 2050 vision and delivering the Public Interest Commitments.

(6) Delivering more nature-based solutions, such as the approach we piloted in our Ingoldisthorpe treatment wetland is essential. However, to deliver these will require both timely investment and significant evolution of the regulatory framework to ensure these goals are achieved. It remains imperative to recognise that the long-term interests of customers and the environment will require increased investment whilst protecting those who may struggle to pay their bills. PR24 needs to deliver a step change in approach to enhancement investment to avoid the risk of delay which would make the whole life costs of such interventions greater than if appropriate action is taken in PR24 now.

(7) Encouragingly, Ofwat's discussion paper and David Black's recent speech[1] recognise the need for increased investment over coming price reviews, and the need to take a long term and adaptive approach to these challenges. We welcome the recognition of the need for more nature-based solutions with an emphasis on making these the norm in the future. We wish to work closely with Ofwat and our environmental regulators to share our experiences as to what has worked well, and what is most challenging, in delivering these solutions.

Purpose and legitimacy

(8) A prerequisite to ensuring a long-term focus and adapting regulatory approaches accordingly is to firmly demonstrate that people can trust their water company to do the right thing. Therefore, the overarching narrative for the sector as a whole - both companies and regulators - needs to be one of trust, alignment and collaboration. This is why the Public Interest Commitment which the sector as a whole has signed up to is framed by an umbrella commitment to place our wider social and environmental purpose at the centre of everything we do.

(9) At Anglian Water we have, amongst other things, enshrined that purpose in our Articles of Association. This means that acting in accordance with this purpose becomes a legal duty for all directors of the company. It embeds a way of working that we have had in place for many years, and requires us to ensure that we are bringing social and environmental prosperity to the region we serve, whilst ensuring a fair return for our shareholders[2]. To this end, and to ensure we are being held to account publicly for delivery against these commitments, we are working with a range of stakeholders on a project with the British Standards Institute (BSI) to develop a new standard on sustainable purpose in business. We expect to publish this for consultation later this year and believe that there are options Ofwat can consider in relation to ethical business regulation (EBR), which links to the purposeful company framework we have established. This can reduce burdens and free up time and resources to deliver more for customers and the environment.[3]

(10) Developing these alternatives will require thinking and engaging differently during the PR24 process if we are to achieve different outcomes for the sector. We are keen to explore how the aspects of ethical business regulation (EBR) could dovetail with the purpose-led businesses and the potential role of negotiated settlements and the options this could open up for a different regulatory approach for PR24.

More significant changes to the regulatory framework are needed to realise the shared long-term ambitions for the sector

(11) There is clear alignment on the scale of challenge and pace required to meet the combined challenged facing the sector. In setting revenues through to 2030, PR24 will determine the water sector's contribution to the UK's climate and environmental goals through to the end of what needs to be a 'decisive decade' of action. By 2030, alongside achieving net zero emissions and the other Public Interest Commitments, the sector needs to accelerate its work to protect rivers, particularly chalk streams, and increase community resilience to the growing impacts of climate change. The

[1] https://www.ofwat.gov.uk/wp-content/uploads/2021/06/David-Black-WWT-Speech-29-June.pdf

[2] Practical applications of this purpose include our Community Recovery Plan, setting out how we will work with partners and policymakers to support long-term sustainable social and economic recovery after the pandemic. Our two-way social contract setting out how we can work together to achieve these positive outcomes, and our green recovery plan following the Covid-19 pandemic. We are also the first utility company to launch green bonds connected directly to achieving our interim carbon targets by 2025.

[3] See Christopher Hodges and Ruth Steinholtz (2017), *Ethical Business Practice and Regulation, A behavioural and values-based approach to compliance and enforcement,* and Sustainability First (2021) *Regulation for the Future*.

Environment Bill will lead to new legally-binding targets being set for both water consumption and water quality, plus the new goal to 'eliminate harm' from storm overflows.

(12) When setting PR24 against this backdrop, it does not seem credible to propose an approach that largely assumes that the overall regulatory toolkit that was in play for PR19 remains fit for purpose for PR24 and beyond. Whilst the document sets out a wide range of areas for potential further work, the central proposition seems to be that only quite minor modifications to the PR19 approach are needed.

(13) There is a risk that, without a detailed review of the regulatory framework against these long-term outcomes, and willingness to consider more radical change in PR24 and in future reviews, the proposals set out in the paper will fall short of what is needed to deliver the aims that we feel are reasonably well-aligned between Ofwat, the sector, Government, and customers.

(14) Merely tweaking the existing building blocks is unlikely to yield the shift required to address these huge future challenges. As set out above, consideration of EBR and purpose-led approaches to regulation would help deliver a longer-term view as well as support a reduction in the need for continued and sustained regulatory intervention, helping to step down from the "peak" in regulation as we discuss later in this response.

(15) In terms of specifics, our central proposals for developing the PR24 framework focus on the following areas:

- A major change to how enhancement expenditure is assessed to ensure timely and effective investment spanning beyond single price control periods;
- Setting long term price path commitments for specific aspects of enhancement like net zero, drought resilience, pollution reduction and strategic growth;
- Developing regulatory frameworks which are capable of delivering strategic regional options which maximise value across multiple beneficiaries, and across multiple AMPs, ensuring water customers make a fair contribution;
- Refinement of the enhancement cost assessment to focus on whole life costs and promote nature based solutions;
- A clear, robust approach to understanding the interaction between cost and service now and in the longer term;
- An improved approach to risk assessment now and in the longer term; and
- The development of forward-looking approaches to capital maintenance requirements.

(16) As the regulatory framework continues to develop for PR24, Ofwat should undertake further analysis to ensure it is striking an appropriate balance between costs, risk and service improvement and give further consideration to the interplay between the proposed incentives and assess whether, taken as whole, they create a regulatory framework which supports the long-term focus and creation of social and environmental value. It is important that PR24 effectively balances these to ensure companies do bring forward plans for the enhancement customers want and the environment needs and are still incentivised to focus on efficiency of costs.

(17) Ofwat has indicated it is considering amendments to a range of tools within the regulatory framework and processes to support its ambitions for PR24, for example:

- Consideration of how ODI incentives should apply across multiple Price Review periods;
- Reducing the total number of ODIs;

- Deriving ODI rates for common measures using national research;
- Adoption of “targeted challenges”;
- Amendment to Business plan incentives;
- Potential “early certainty” mechanisms for ODIs for good plans;
- Amendments to cost sharing rates, including potential links to asset health performance;
- Potential early company submissions to Ofwat on enhancement and ODI rates;
- Ofwat to provide companies its early view on botex models; and
- Potential removal of the Initial Assessment of plans phase from the overall timetable.

Net Zero

(18) We also welcome Ofwat’s broad support for the challenge of reaching net zero emissions. However, if we are to meet the ambitious sector goal of net zero by 2030, the decisions made in PR24 will be critical in enabling this ambition to be met. Carbon reduction is a long-standing priority in our region. This is why we became the first company globally to achieve the international standard for managing infrastructure carbon[4] and championed the 2030 sector-wide goal in the Public Interest Commitment.

(19) These efforts resulted in the sector unveiling a ground-breaking plan to deliver a net zero water supply for customers by 2030; the world’s first sector-wide commitment of its kind. The Net Zero 2030 Routemap[5], developed using over a decade’s worth of detailed data, provided water companies with a framework within which to develop and cost their own net zero action plans. We have done just that. Our Net Zero by 2030 strategy[6] sets out our targets and the actions we propose to take to get us there.

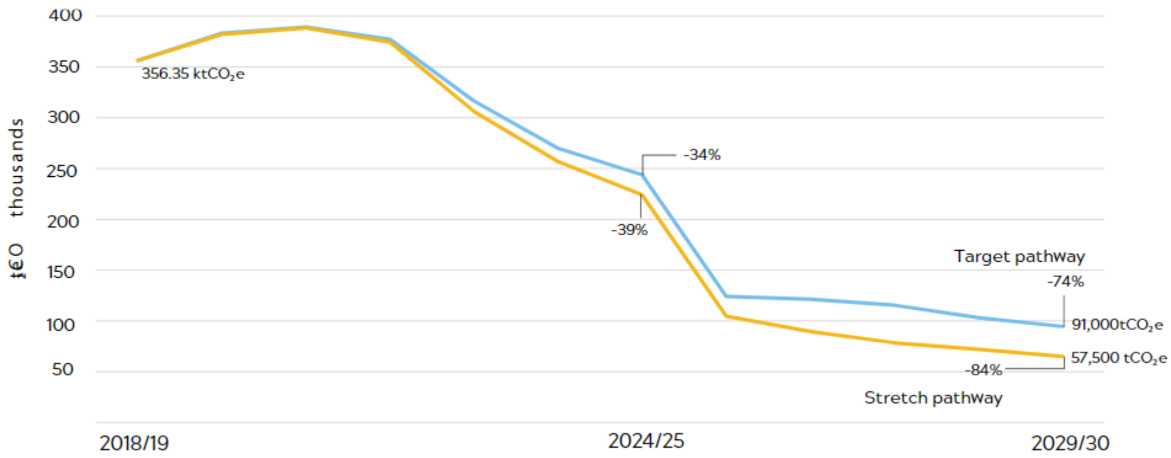
(20) By 2030 our goal is to have a 70% reduction in capital carbon[7] and net zero operational carbon[8]. Our strategy to reach these goals follows a three-step hierarchy, to:

a. *Reduce emissions* by embedding behaviours aligned with net zero in Anglian Water and our supply chain, embracing and scaling innovations that improve energy and resource efficiency and on land we own, deploying catchment-scale and nature-based solutions to improve water quality and reduce reliance on engineered infrastructure.
b. *Decarbonise our electricity supply* by installing solar and wind private wire power purchase agreements, combined heat and power, green electricity procurement, sleeving and energy storage.
c. *Remove / offset our residual emissions.* Carbon sequestration projects managed directly by us, within our boundary, or that we invest in. We will work with third parties to offset our residual emissions, prioritising schemes in our region, supporting local businesses and our community.

(21) Our pathway will cut net emissions by 34% by 2025 and 74% by 2030. This will leave us with 60-90,000tCO_2e to offset and further reduce beyond 2030 to meet and maintain net zero.

[4] Certified to PAS 2080 - carbon management in infrastructure
[5] https://www.water.org.uk/routemap2030/
[6] https://www.anglianwater.co.uk/environment/carbon-management/the-routemap-to-net-zero-carbon/
[7] Scope 3 emissions, from our 2010 baseline
[8] Scope 1 and 2 emissions and some Scope 3 for outsourced operational activities

Our pathway to net zero operational carbon



(22) However, the pathway cannot be achieve without appropriate support through the regulatory system. We would therefore suggest that "delivering net zero" be added as a theme for PR24. We would also ask that Ofwat should set out how companies should best articulate this in their plans, and how Ofwat intends to ensure it can allow for efficient costs for delivering the pathway to net-zero carbon in PR24.

(23) In this submission, we have provided some initial thoughts on these changes "in isolation". Clearly, the overall impact of these amendments, in addition to other areas such as cost assessment and risk and return will need to be assessed as a total framework. We would urge Ofwat to consider the incentives package as a whole and consider the coherence of how all these changes would support the long-term goals set out in the document. As recently discussed with Ofwat, we propose to carry out further work in this area over the summer, for submission to the Futures Ideas Lab and discussion with Ofwat.

Coming down from the peak

(24) PR19 has previously been described as "peak regulation", with indications that PR24 should allow for reduced burdens in terms of time and cost. However, the discussion document offers little promise here. There is a risk that PR24 misses the opportunity to re-think whether the existing level of complexity creates the clarity and focus in the areas that matter most to customers, society and the environment. Applying some of the core components of EBR in PR24 could enable a significant easement from intrusive approaches.

(25) Ofwat has proposed some areas to streamline the process in future, including the potential removal of the initial assessment of plans phase of the price review process. This streamlining is not the same as reducing complexity and may actually remove a critical step in the process for companies, customers and Ofwat to explore potential opportunities and areas of divergence.

(26) We continue to see value in having an initial assessment of plans step in the process. In line with the proposals to share with companies Ofwat's early view on weighted average cost of capital, ODI rates and base costs, retention of this step would enable a more targeted focus on both regional specifics and a targeted review of enhancement expenditure to deliver against long term challenges. We would

also like to further explore the scope and timing of potential early company submissions and how this could be beneficial to the overall PR24 process.

The need for a major change to the assessment of enhancement costs

(27) In particular, the approach to setting enhancement allowances associated with very significant drivers of investment appears to focus on minor changes to improve the previous approach to cost assessment. We believe that, by contrast, a fundamental re-think is needed, to assess whether multi-AMP sustained investment of the type expected for major enhancement proposals such as new reservoir systems remains a good fit for five-year price controls or whether a more radical approach is required.

(28) In general, we think there is a real opportunity in PR24 to more clearly differentiate between base costs and enhancement driven expenditure to ensure that, as is the case in the recent WICS price determination, companies remain robustly challenged to continue to improve their efficiency on base costs, whilst still enabling Scottish Water to deliver the step change that is needed for investment to achieve the net zero carbon and other longer-term ambitions.

(29) Similarly, we consider that there are other areas of the PR24 strategy that would benefit from taking a step back and demonstrating how the building blocks will work together to give deliver a successful price review in the round, including:

- Greater clarity on how all the reforms will come together both for PR24 and future reviews to deliver against the long-term aspirations Ofwat and the sector are seeking to deliver;
- Giving due time and consideration to reflect on how the approaches for key parts of the regulatory framework - such as approaches for growth, forward looking approaches to capital maintenance and enhancement expenditure - form a coherent and well targeted suite of incentives and approaches;
- Clarifying how base costs, enhancement expenditure, and the ODI framework will interact, such that companies are appropriately remunerated to deliver stretching outcomes for customers and the environment without in advertently creating a cost service disconnect; and
- Clarifying the driver for adjusting the water resources price control boundary which is currently unclear.

(30) We welcome the emphasis in the paper to review future approaches to the assessment of growth expenditure (which is broader than just developer services), the assessment of future capital maintenance requirements and seeking to ensure that regulatory process promotes rather than prohibits nature-based solutions. Some of this work has commenced through a range of Water UK working groups and Ofwat's own cost assessment working group. It will be important to ensure that all the priority areas are identified quickly to allow sufficient time to develop alternative approaches.

(31) We welcome what we see as a change in the proposed assessment of resilience, with a greater focus on operational resilience for PR24. This aligns with the draft Strategic Policy Statement and the previous National Infrastructure Commission which recognised the costs of proactively building in resilience over the long term were almost half of those associated with emergency measures in the event of failure[9]. We set out in chapter 10 our views that Ofwat should strengthen incentives for long-term operational resilience by fully adopting the Cabinet Office Infrastructure Resilience components framework.

[9] National Infrastructure Commission April 2018 – Preparing for a drier future

Exploring further improvements to cost assessment

(32) In general, the Ofwat discussion paper highlights the right areas of focus for exploration. The commitment to explore and improve assessment of enhancement costs, accounting for net zero, nature-based solutions whilst taking better into account societal and environmental benefits are fully supported.

(33) We also support the commitment to strengthening approaches to long-term operational resilience and the forward-looking pressures on capital maintenance, work on which has commenced through one of the Water UK subgroups.

(34) We note that the approach to growth funding materially changed during the PR19 process. Given the high growth pressures faced in the East of England, improvements are needed for PR24, and we want to work closely with Ofwat to develop these. Early clarity on the assessment approach and the balance of *ex ante* versus *ex post* mechanisms will be needed. Again, this is currently being explored by a Water UK subgroup.

(35) Ensuring robust approaches to cost assessment can also be reflective of regional differences will be a critical success factor for the upcoming review and beyond. This requires a clear understanding of the links between costs, service and risk in setting future allowances and targets. This was partially explored during the CMA redetermination process, which challenged the strength of the statistical relationships between cost efficiency and service performance used to support Ofwat's stretch in setting PR19 targets. The absence of a clear understanding of how this related to the costs of each individual company to achieve a given level of service was noted.[10] The CMA also looked in detail at companies' proposed leakage costs associated with both maintaining and improving service, recognising these vary significantly dependent on the level of service, regional factors and the current technology deployed.

(36) The relationship between cost and service warrants further exploration to avoid unintended consequences for companies and perverse incentives which detract from the longer term focus we and Ofwat agree is imperative.

The relationship between innovation, efficiency, productivity

(37) One of the proposed ambitions for PR24 is efficiency and innovation. We consider that rather than an ambition, driving efficiency is a core part of Ofwat's role in any price review. Innovation appears to be framed within the document as a way to facilitate efficiency improvements, though we encourage Ofwat to steer away from this inference. Not all innovations are directly focused on efficiency improvements with a view to lower costs for the same level of service. If they were, they would be taken forward as business as usual activities, rather than being facilitated by initiatives such as Ofwat's innovation competition. Innovation has an important role in unlocking long-term changes for the sector, such as smart automated networks and new ways of working that will reduce carbon emissions which are not necessarily encouraged through 5-year investment cycles.

(38) The document fails to set out Ofwat's approach to Frontier shift at PR24. We would urge Ofwat to undertake or commission new analysis of quality-adjusted productivity in the water sector, building on the 2017 Frontier Economics study. We request that Ofwat return to its prior approach of seeing productivity and RPE holistically rather than as separate topics like it did in PR19.

[10] Specifically CMA Final report para 4.221

Risk and return

(39) This is the area where Ofwat seems to be most at odds with the recent CMA redetermination. There is a risk that departure from the CMA's conclusions could undermine the longer-term focus implied by the consultation and the need to ensure sustained investor confidence in the regulatory regime if the step-change increase in investment to address the challenges we face is to be delivered.

(40) On financeability, we note that Ofwat raises the possibility of exploring changes to assumptions on gearing in the notional structure, the potential for cost of equity indexation and rate of transition from RPI to CPIH indexation. Many of these were explored and rejected in the recent CMA redetermination. The merit of further exploration of these issues now is not clear, given the need for clarity and certainty to encourage the investment which Ofwat recognises is needed in the long term. It is also not clear why Ofwat considers this a priority in light of the long-term context upon PR24 will be built.

(41) We support the emphasis from Ofwat seeking to understand the balance of risks facing companies and customers and develop a more consistent approach. This will be important given the need to balance risks in the shorter and longer term. Whilst there is clear merit in developing either common methodologies or guidance, this framework will need to be able to allow the robust company specifics given risks will be informed by a range of factors which will vary across the sector. We detail in our response to question 11.2 elements which need further consideration and would welcome the opportunity to work with Ofwat when developing methodologies for risk quantification.

Customer engagement

(42) Whilst potentially unintended, the emphasis on national customer research, performance commitment levels, centralised ODI rates, and reduced significance of bespoke performance commitments and ODIs creates a risk that PR24 "centralises" core aspects of the process and diminishes the importance of companies' putting customers at the heart of their business plans. This could act to muffle the regional stakeholder and customer voice for PR24 and be a retrograde step after a decade of progress which has seen material improvements in how customers have engaged and directly influenced plans and priorities. It is therefore important that the collaborative customer research is developed collaboratively with customers and delivered in a timely way. This can ensure that companies can still undertake their own research. We would suggest that Ofwat considers how best to incentivise this, including by setting out how high-quality customer engagement will be given weight in the regulatory process.

(43) To that end, we will maintain our Customer Engagement Forum to provide independent assurance that the customer engagement we are undertaking is robust and well directed, and that we faithfully reflect the outcomes of that engagement in the business plan we put forward for PR24.

(44) We are encouraged that Ofwat remains interested in the potential benefits of negotiated settlement approaches and how these may be usefully reflected in the Price Review process and which areas of companies' plans may be most suitable for negotiated settlement.

Evolving markets

(45) There is a clear continued emphasis on the role of markets, which we welcome. This will be particularly relevant given the ongoing development of potential strategic regional solutions where a functioning DPC market will help to ensure best value can be achieved. Positive progress continues to be made working collaboratively with RAPID on areas such as commercial and contractual considerations which will be vital to unlock the potential benefits of multi-sector multi-beneficiary

investments which maximise value in public water supply and beyond. This is in addition to the ongoing DPC process taking the Middlegate water treatment works through DPC during AMP7 which we believe provides an important test-bed for new processes and to ensure that there is no diminution in the level of assurance over key outcomes such as water quality. We want to work closely with Ofwat as the Middlegate scheme progresses, and to draw lessons for the deployment of DPC more widely in AMP8 and beyond.

(46) We are also committed to supporting the work of RAPID in developing proposals for the regulatory and commercial framework for strategic water resources solutions. We recognise the critical importance of the regional planning process in securing future water resources for all sectors in our region and are closely supporting Water Resources East. We are working in collaboration with Affinity Water and Cambridge Water on the development of new multi-sector reservoir systems and associated strategic transfers, which we expect may lead to major new water resource options being proposed at PR24 which may warrant a quite different regulatory treatment in line with the arguments we make above about splitting out the consideration of enhancement schemes from the approach to ensuring efficiency of base costs.

(47) We support the development of effective markets in bioresources and took the lead on quality assurance through setting up the Biosolids Assurance Scheme (BAS). We continue to look for both short- and long-term trading opportunities with contiguous WaSCs. However, as set out in our letter to Ofwat dated 15 December 2020 (published on Ofwat website 21 May 2021), there are considerable barriers to the development of the market that will constrain the effect of any regulatory changes.

Concluding remarks

(48) The overall direction set by Ofwat in the discussion document is positive. This demonstrates the potential for commitment to a long-term focus and greater environmental and social value to be reflected within the price review process. This will be key to deliver ambitions on improved resilience to drought and flood, reduced pollutions and the delivery of net zero carbon emissions by 2030.

(49) If these ambitions are followed through into the PR24 methodology in a way which aligns with companies' greater focus on these priorities as demonstrated through Anglian Water's Purpose, and the sector's Public Interest Commitments, then PR24 could deliver real improvements and lasting change, with significant benefits for communities and the environment for decades to come. However, our main concern is that there is not yet sufficient change being signalled from PR19 to enable these ambitions to be realised.

(50) In our responses to the specific questions set out in the remainder of this response, we highlight particular areas of support as well as a number of areas where we consider there is a need for reconsideration or scope for further development ahead of the draft methodology publication in order to successfully work towards delivering the ambitions set out in chapter 2. We would welcome the opportunity to work with Ofwat on these areas to help develop the design of the PR24 price review further.

Chapter 2: Ambitions for PR24

Key Points

(51) We welcome the greater focus on delivering long-term and environmental and social value in Ofwat's ambitions for PR24. These set the right direction for the industry and closely align with our own Purpose to create environmental and social prosperity in the region we serve through our commitment to Love Every Drop. We also support the continued focus on customers and communities in these ambitions. However, we see 'efficiency' as being a core part of Ofwat's role in the price review rather than an ambition and 'innovation' as a key enabler for the ambitions rather than being an end in itself. Achieving net zero carbon emissions is currently a clear omission from the themes. We would propose that, given the fundamental changes to ways of working that achieving net-zero by 2030 will require from the sector, this should be included as a theme for PR24 in its own right.

(52) The responses in this section set out further detail on how we consider these themes need to be translated practically into the price review if the ambitions they contain are to be realised. We would welcome the opportunity to work with Ofwat to further develop the design of PR24 to ensure it delivers the ambitions.

Responses to individual consultation questions

Question 2.1 Do you agree that the themes we have suggested for PR24 are appropriate for England and for Wales?

(53) We believe that overall, the focus on long-term, customers and communities, and environmental and social value is appropriate for PR24 and aligns with the direction that customers and stakeholders would like to see the industry take. We also consider that these themes align well with Anglian's own Purpose to deliver social and environmental prosperity to the region we serve through our commitment to love every drop. However, we consider that 'efficiency and innovation' theme to be a core part Ofwat's role rather than an ambition and suggest that this shouldn't be one of the themes for PR24.

(54) Instead we would support the inclusion of delivering net zero carbon emissions by 2030 as a theme for PR24. While this could be viewed as driving part of the 'focus on long term' and 'environmental and social value' themes, the scale of the task ahead of the industry on delivering net zero alone will require a fundamental change in the way that the industry operates. We therefore consider that an explicit 'net zero' theme is needed to reflect the systemic impact this ambition will have across companies' entire business plans. Water UK's Net Zero routemap[11] highlights what is needed from the sector and Ofwat in PR24 to deliver net zero.

(55) In particular:

- *Focus on the long term:* The long-term focus ambition is a welcome addition to the ambitions for PR24. Whilst 'resilience' is not included explicitly as an ambition, we expect the long-term ambition – whilst taking a broader view – to consider resilience as a key part of this ambition. At PR19 we set our 5 year business plan within the context of our 25 year Strategic Direction Statement (refreshed in 2017[12]), and we view our PR24 plan as a key step on the way to

[11] https://www.water.org.uk/routemap2030/wp-content/uploads/2020/11/Water-UK-Net-Zero-2030-Routemap.pdf
[12] https://www.anglianwater.co.uk/siteassets/household/about-us/revised-strategic-direction-statement-2020-2045.pdf

meeting the four long-term ambitions agreed with our customers and set out in that SDS[13]. At PR24 it will be important that this long-term view feeds into Ofwat's assessment of capital maintenance needs and whole life cost assessment.

- *Understanding customers and communities:* Companies' plans must be tailored to meet the interests of the customers that they serve. Each company has a unique and diverse customer base. It is therefore vital that each company has a clear understanding of the priorities and preferences of their specific customer base and that this is reflected in the business plans they put forward. Linking to the environmental and social value ambition, it is also important that customers are seen as citizens and stakeholders who are affected by the wider impacts that water companies have in their region, beyond the direct provision of water, water recycling and retail services. This should feed through into the cost assessment and ODI framework at PR24.
- *Environmental and social value*: This ambition closely aligns with Anglian's Purpose. The recognition that companies deliver wider value beyond their immediate roles in providing safe clean water to customers and returning used water safely to the environment is welcomed. We would like to see a greater focus on best value plans at PR24, which will require companies to clearly demonstrate, and Ofwat to assess, where there are wider social and environmental benefits to their plans, which offer greater benefits than traditional solutions which may be lowest short term cost . Our evolving 6 Capitals Framework may provide some useful pointers here, which we would be happy to share with Ofwat if useful.
- *Efficiency and Innovation:* While we consider efficiency and innovation to be an important part of Ofwat's role in holding companies to account, we consider efficiency to be more a core function of economic regulation than a particular ambition for PR24. It is also important to recognise that whilst innovation can often uncover more efficient ways of doing things, it is not only about reducing costs. Many of the projects which have been successful in attracting innovation funding for example, have been about delivering greater environmental and social value, improving service and improving resilience. We highlight in response to the cost assessment chapter that, in assessing efficiency, Ofwat should consider the impact that quality of service provision has on costs (leakage being a particular example where straight unit cost comparison is not appropriate). We also highlight that it will be important to consider how best to measure productivity in the sector.

(56) The emphasis of these ambitions will also be complemented by the forthcoming Defra Strategic Policy Statement reflecting the Government's priorities for PR24. It may be appropriate to reconsider these ambitions in light of the publication of the draft statement, and the final statement, to ensure that the final SPS are appropriately reflected in the mechanics of PR24. We also propose that Ofwat sets out as part of its PR24 Methodology how it will demonstrate that its Draft Determinations and Final Determinations are meeting the SPS priorities.

[13] Make the East of England resilient to the risks of drought and flooding; Enable sustainable economic and housing growth in the UK's fastest growing region; be a carbon neutral business by 2030; work with others to achieve a significant improvement in ecological quality across our catchments

Question 2.2 Do you have comments on the considerations we've identified as relevant to the design of PR24?

(57) Ofwat has set out that it will: a) consider providing more clarity of future price reviews;b) look to streamline the price review process; and c) will reflect local and national diversity in the price review. We consider each of these in turn below.

Clarity of future price reviews

(58) On providing more clarity in future price reviews, there are a number of ways in which this earlier certainty would be beneficial. For example, continuity in performance commitments measured and incentive structures could avoid a situation where companies that make early improvements are subsequently penalised through the inclusion of ODIs which require improvement from a baseline (e.g. leakage PCLs at PR19 are based on a % reduction from companies' own performance baselines which vary widely between companies – thus making the % reduction target more difficult for those that have already made significant improvements).

(59) However, greater clarity upfront needs to be balanced against the fact that customer views and the needs of society and the environment will evolve over time. Therefore, any multi-AMP approaches need to factor in these likely changes. For example, we see less benefit from setting potential ODI rates in advance of a price review as these should be driven by societal and customer valuations which may change between reviews. Multi-AMP approaches must not mean reopening of previous price reviews as this could also dampen incentives to make significant improvements in priority areas.

(60) More broadly, Ofwat is considering a range of incentive mechanisms as part of its PR24 framework including targeted challenge ODIs, multi-AMP ODIs, early certainty mechanisms and linking cost sharing rates to asset health. We would urge Ofwat to consider the incentives package as a whole, whether this works coherently and if it will help deliver the outcomes that customers want and the environment needs. It should also balance this against its broader considerations of reducing the complexity of the price review.

Streamlining the price review process

(61) The document appears to conflate streamlining of the price review process with simplification. We would suggest Ofwat separately considers wider options for streamlining the price review process (e.g. the number of steps in the price review) and simplification which refers to the technical complexity of the process and the regulatory burden created.

(62) The complexity of the price review needs to be weighed against the potential benefits of greater granularity, such as for building understanding of cost and service relationships. For example, we have been working well with Ofwat on potential cost and service data on leakage and metering to support the price review process. We would propose that Ofwat explicitly assesses the options for simplification of the process against the principles of better regulation and includes this analysis in its next iteration of the PR24 framework[14].

[14] Department for Business, Energy & Industrial Strategy ('BEIS') 'Principles for Economic Regulation' (2011) and the Better Regulation Executive's 'Better Regulation Framework: Guidance' (2018).

Local and national diversity

(63) We strongly support the reflection of regional and local diversity within the price review process. Key to this will be making sure that company plans are reflective of regional customer and stakeholder priorities and preferences. To ensure that diversity is reflected in the price review and customers feel their engagement is worthwhile, companies need the ability to demonstrate that they are acting on the engagement they have had with their customers. It will therefore be very important to recognise where there are differences between companies in this respect to avoid incorrect assumptions of areas where there is comparability between companies and local views are given less importance. The price review should avoid overreliance on national research, particularly where there is clear and strong evidence presented by companies of regional variations in customer views.

(64) The design of the price review must also ensure that procedural issues do not interfere with the achievement of the ambitions. Ofwat should fully understand the incentives created through its price review structure and the consequences this could have on companies' approaches to PR24 (e.g. whether any fast-tracking or cost sharing rates overly encourage companies to put forward lowest cost, rather than best value plans). The design of the price review should allow companies to reflect longer term impacts of Covid-19 which were not known during the PR19 process and have since led to more permanent changes (e.g. embedded shifts in working patterns are having a significant impact on where and how people work, resulting in PCC changes). The price review must also enable and encourage more partnership working within catchments.

(65) We would welcome the opportunity to continue to work with Ofwat to develop the price review design so that it can incorporate the points above .

Question 2.3 How should we evaluate our progress, and how can we best develop or use appropriate metrics to do so?

(66) We welcome the exploration of evaluation tools to assess Ofwat's progress in delivering on its ambitions. This is a challenging area to assess. Whilst outcome-based measures are typically best for monitoring and incentivising companies progress in delivering their plans, they are less appropriate for evaluating Ofwat's progress. This is because outcome-based performance measures are affected by a range of factors beyond Ofwat's success in delivering its PR24 ambitions (e.g. if companies were not to meet their outcomes, this should not necessarily be viewed as Ofwat not making satisfactory progress in its ambitions, or vice versa where companies perform strongly).

(67) Instead, it would be more appropriate for progress to be monitored through setting tests upfront for what should be reflected in the price review methodology and determinations to enable the four ambitions to be delivered. Criteria could include for example that "Ofwat has a mechanism in its price review to reflect long-term value delivered within its cost assessment approach", or that "Ofwat's methodology and determinations allows local diversity of customer views to be reflected in its price review". We would welcome the opportunity to work with Ofwat to develop such metrics further and provide further thoughts on how this could be evaluated.

(68) It is imperative Ofwat works with the sector to develop effective evaluation criteria to assure customers and policy makers that it is regulating in a way that will enable the sector to deliver against Ofwat's stated ambitions, those in the forthcoming SPS, and the priorities of customers.

Chapter 3: How we regulate

Key Points

(69) Ofwat proposes to place increased emphasis on delivery of long-term outcomes for customers, communities and the environment. This aligns with our company's Purpose, now formally part of our Articles of Association, to bring social and environmental prosperity to the region we serve through our commitment to Love Every Drop.

(70) We agree that the fundamental regulatory building blocks should be maintained. However we would suggest that Ofwat undertake a detailed review of whether the regulatory framework is fit for purpose to deliver these long term outcomes, and be willing to consider more radical change. As it stands, the proposals set out in the paper will fall short of what is needed to deliver aims that we feel are reasonably well-aligned between Ofwat, the sector, Government, and customers. Merely tweaking the existing building blocks is unlikely to enable the scale of change required to address these huge future challenges. It is also important that these building blocks remain appropriately balanced to ensure the sector remains attractive for investment, to meet the long-term challenges. We are keen to explore how the aspects of ethical business regulation (EBR) can dovetail with purpose-led businesses and the potential role of negotiated settlements to shape PR24 and deliver better and less burdensome regulation.

(71) We believe that co-ordination across the sector can deliver significant benefits to consumers and the environment. We have championed co-ordination, both within and outside of the water sector, through the development of Water Resources East. We believe that a multi-sector, multi-beneficiary approach will deliver the best value, but that this may need quite different regulatory approaches to realise this. We welcome the development of Regulators' Alliance for Progressing Infrastructure Development (RAPID) and its efforts in considering such options.

Responses to Individual consultation questions

Question 3.1 How can we best regulate the water sector to deliver value for customers, communities and the environment? Do you agree, or have comments on, our proposal to maintain our 'building block' approach based on outcomes, costs and risk and return?

(72) We suggest that Ofwat undertake a detailed review of whether the regulatory framework is fit for purpose to deliver these long term outcomes, and be willing to consider more radical change. As it stands, the proposals set out in the paper will fall short of what is needed to deliver aims that we feel are reasonably well-aligned between Ofwat, the sector, Government, and customers. Merely tweaking the existing building blocks is unlikely to enable the scale of change required to address these huge future challenges. It is also important that these building blocks remain appropriately balanced to ensure the sector remains attractive for investment, to meet the long term challenges, in the future.

(73) In terms of specifics, our central proposals for developing the PR24 framework focus on the following areas:

- A major change to how enhancement expenditure is assessed to ensure timely and effective investment spanning beyond single price control periods;
- Setting long term price path commitments for specific aspects of enhancement like net zero, drought resilience, pollution reduction and strategic growth;

- Developing regulatory frameworks which are capable of delivering Strategic Regional Options such as new reservoir systems and which maximise value across multiple beneficiaries, and across multiple AMPs, ensuring water customers make a fair contribution;
- Refinement of the enhancement cost assessment to focus on whole life costs and promote nature-based solutions;
- A clear, robust approach to understanding the interaction between cost and service now and in the longer term;
- An improved approach to risk assessment now and in the longer term; and
- The development of forward-looking approaches to capital maintenance requirements.

(74) We fully support the early visibility of base cost models, performance commitment levels and outcome delivery incentives. For this to aid Business Plan development, the models must be made available by the start of (calendar year) 2023 at the latest.

(75) How these building blocks are calibrated, and the resulting balance of risk and return should be informed by the CMA's recent re-determination for four companies. It is important that these building blocks remain appropriately balance to ensure the sector remains attractive for investment, to meet the long-term challenges, in the future.

Question 3.2 To what extent is greater co-ordination required across the sector

(76) We believe that co-ordination can deliver significant benefits to consumers and the environment, both within and beyond the sector. We seek to do this on every level, from strategic water resources and growth groups to working with local councils and other stakeholders. We set out below some examples that we think could be built on for PR24.

(77) We have championed co-ordination, both within and outside of the water sector, through the development of Water Resources East (WRE). WRE's vision is for Eastern England to have sufficient water resources to support a flourishing economy, a thriving environment and the needs of its population. WRE also wants the region to be seen as an international exemplar for collaborative integrated water resource management. WRE is made up of nearly 200 members from a diverse range of sectors and is developing a long-term strategy for water resources in the East of England. This is likely to include multi-company and multi-sector strategic options.

(78) We formed a Utilities Alliance last year that includes Cadent, Openreach, SGN, Thames Water, Western Power and UKPN as providers of essential infrastructure covering energy, water and broadband across the OxCam Arc area. The aim is that by working closely together we will help accelerate sustainable economic and housing growth in the OxCam Arc and improve the speed and environmental performance of infrastructure delivery. The chancellor of the exchequer, Rishi Sunak, has welcomed the initiative and its "commitment to joined-up delivery of infrastructure in a key area of the UK's economy". We believe initiatives like this should be encouraged through the PR24 framework.

(79) We are also working with WRE, the Environment Agency and other regional partners on the Future Fens: Integrated Adaptation project. This project looks at the potential to combine flood risk alleviation with the provision of water for public supply, energy and agriculture and the opportunity for social regeneration and sustainable new housing as a result. We believe this kind of holistic thinking can unlock new opportunities to build back better from Covid-19 and adapt to climate change and again should be supported through the PR24 process.

In what ways might we promote better co-ordination across companies and with other sectors, and how might this benefit customers?

(80) We believe that a multi-sector, multi-beneficiary approach will deliver the greatest benefits, such as we have developed through WRE. We welcome the development of Regulators' Alliance for Progressing Infrastructure Development (RAPID). We believe Ofwat should build on this success and engage early in the regional Plan and WRMP development processes. This would enable Ofwat to get a greater understanding of option assessment, customer and wider stakeholder views, and provide challenge as needed during this part of the process. That in turn would allow Ofwat to focus on scrutinising cost efficiency of schemes coming forward during the PR24 process, rather than again challenging the need for those schemes.

Chapter 4 Increasing focus on the long term

Key Points

(81) We fully support a greater focus on long-term for PR24 and beyond. The proposed approach to setting companies' business plans within longer-term plans chimes with how we updated our Strategic Direction Statement, reflecting our challenges and ambitions for the next 25 years, to frame our PR19 business plan. We propose to continue to use our SDS to frame our PR24 plans.

(82) There are several aspects of the regulatory approach which would benefit from a deeper consideration of how to ensure a greater focus on the long-term. Examples include:

- Differentiating between base and enhancement which could include separating enhancement assessment out from the typical 5-year cost assessment approach to consider multi-AMP costs and benefits;
- Linked to this, cost assessment should consider whole life costs of enhancements (not just costs over a 5-year time horizon) and the value added by nature-based solutions over more traditional approaches;
- Taking the sector's commitment to Net Zero into carbon emissions account within the price review; and
- Taking a long-term, forward-looking approach to capital maintenance needs.

(83) We would suggest Ofwat's future priorities include a focus on these matters. This will help to avoid the need to make retrospective adjustments to the WaCC and financeability.

(84) We also support the proposal to publish indicative views on botex, performance commitments and WaCC in advance of business plan publications to support the focussing of business plan on long-term enhancements. This gives companies greater certainty when engaging with customers on specific aspects of their business plans and provide clarity on where areas of divergence between companies and Ofwat may exist. It will be important that these are published in time to allow companies to engage with customers on their overall plans in light of these indicative views.

(85) We support the principle of ensuring that incentives are set in a way which drives companies to consider performance in a long-term context. We feel that the framework could be made more certain by maintaining performance commitments over multiple AMPs under the existing performance payment structure. This would ensure that any rewards earned in one year are returned through underperformance penalties if performance is not maintained. Where long-term expectations are made in strategic plans, it is sensible for these to be considered as likely commitments for the future.

(86) However, we are concerned that some of the proposals would not encourage longer term thinking. For example, applying outperformance payments over time with a delay dependent upon the continued achievement of outcomes being delivered would in fact weaken long-term incentives. Withholding these payments would make return on investment less certain and therefore discourage companies from making these investments. We also consider that the proposal is a shift away from the principle that rewards and penalties should be paid as close as possible to the time at which the performance level was achieved. This more closely reflects the experience of competitive markets.

(87) We are concerned that whilst there is a clear focus on the long-term in *PR24 and beyond* and multiple reference to the importance of delivering net zero, WRMPs, DWMPs etc. there is no reference to ensuring clean, safe drinking water within this suite of long-term strategies. This is particularly

important in the context of lead and the scale of investment that will be required in this area in coming AMPs. The DWI considers lead to be the biggest public health issue that our customers face and that in order to address this in the coming AMPs there must be a step change in the activity undertaken by all companies. Given the public health implications of lead and the scale of investment required, the commitment to being lead free by 2050 must be considered alongside the other long-term challenges referenced in the document. Further to this, there are important links between lead and other parts of the approach to PR24 including the environmental value of reducing the amount of chemicals used for lead treatment, leakage, and potential opportunities for innovation in this area. We are working very closely with the DWI in the development of our long-term lead strategy and what this means for our AMP8 plan: companies and customers must also have confidence that Ofwat's approach to assessing lead enhancement at PR24 aligns with the approach supported by customers and DWI.

Responses to Individual consultation questions

Question 4.1 What are your views on the need for greater focus in companies' regulatory business plans on how they will deliver for the long term?

(88) Evolving the regulatory framework to place greater focus on the long term and how the 5-year business planning process reflects this is very important. A short term 5-year view risks being damaging to customers and the sector, both in terms of cost and the service that customers receive.

(89) During the development of our PR19 plan we refreshed our Strategic Direction Statement (SDS) which sets out our challenges and ambitions over a 25-year period. We set out our 5-year plan within the context of these longer-term priorities and we are pleased to see that Ofwat's thinking is to view 5-year business plans as staging posts towards the achievement of long-term goals set out in documents such as our SDS. This also links to our other long-term plans including our WRMP and Water Recycling Long Term Plan (WRLTP), and the changes we have made to our organisational structure to bring water resources and strategic growth teams into our Strategy and Regulation business area, alongside our business planning and price review teams.

(90) The focus on the long-term closely aligns with Anglian's Purpose, enshrined in our Articles of Association to deliver environmental and social prosperity to the region we serve through our commitment to Love Every Drop. We are focussed on sustainable, lasting prosperity and thus a greater focus on the long-term in the assessment of company plans would support this.

(91) Consistent with expecting companies to show how their plans deliver for customers and the environment in the long term, Ofwat's regulatory framework and assessment will also need to clearly demonstrate its long-term focus. This could include evolving the approach to assessing enhancement expenditure, including appropriate whole-life cost assessment of alternative options, and splitting this more clearly away from the shorter-term considerations of challenging efficiency of base costs.

(92) Ofwat should consider how to assess plans in order to ensure that companies are delivering best value on a multi-AMP basis, incorporating whole life costs and the additional benefits delivered to customers and the environment of the plans being put forward. Therefore, to align with companies' greater focus in business plans on long-term, cost assessment should include:

- The social and environmental value delivered by investments (e.g. as part of the optioneering assessment for enhancement investments)
- How PR24 plans will form part of a longer-term view of resilience

- A forward-looking view of capital maintenance
- Consideration of multi-generational impacts on 5-year plans (both in terms of bills and service received). This should incorporate a range of customer views including future customers.

(93) We would welcome an opportunity to discuss how these points could be approached and included in the PR24 methodology.

Question 4.2 What should long-term strategies seek to cover and what details should we expect companies to set out in business plans? Would common requirements help us and other stakeholders to understand each company's approach?

(94) Ahead of the publication of Anglian's PR19 business plan, we refreshed our Strategic Direction Statement which set out our key challenges and ambitions for the next 25 years. The process of refreshing the SDS and engaging with our customers on this long-term context allowed us to set our PR19 plan within a longer-term framework.[15] We have also established our governance structures such that our WRMP24, DWMP24 and AMP8 WINEP strategies are aligned, with oversight from our Future Resources Strategy Group. This group plays an integral part in the development of our long-term plans as part of our PR24 business plan development.

(95) To ensure all companies can reflect the needs of their region and preferences of their customers, we would steer away from over-prescription of the content of long-term strategies. For example, the Anglian region being particularly dry and with high population growth means our long-term plans focus on ensuring we balance supply and demand. For other companies this will be a less pressing issue, and other priorities may have greater focus. The identification of regional challenges and agreement of key priorities/ ambitions for the next 25 years may be a standard expectation of long-term plans, though beyond these principles we consider that prescribed requirements of long-term plans should be limited and instead be identified by companies themselves.

Question 4.3 How could this build on the work completed in strategic planning frameworks?

(96) Setting business plans within a longer-term context presents an opportunity for companies to present their business plans in the context of all the relevant strategic planning frameworks. Longer term plans should reflect the direction of frameworks such as WRMP, DWMP, WINEP to give a rounded view of the company's strategic direction and support the development of good 5-year plans.

Question 4.4 How can we allow such strategies and plans to adapt to new information at future reviews while continuing to hold companies to account to deliver expected benefits into the future?

(97) It is important that long-term plans strike the right balance between setting a clear long-term pathway for companies, of which each 5-year plan presents a staging post, whilst also recognising that long-term priorities and customer and stakeholder priorities will evolve over time. We have taken an adaptive planning approach to our development of our WRMP, and our WRLTP and consider that this should be reflected in refreshes to ensure that that regular engagement is reflected in long-term plans and they do not become outdated. As part of these refreshes, companies should set out what updates

[15] https://www.anglianwater.co.uk/siteassets/household/about-us/revised-strategic-direction-statement-2020-2045.pdf

have been made to their long-term plans and what has informed these changes. Doing so would allow external scrutiny of these plans to hold companies to account for any changes made to plans.

Question 4.5 Would providing our views on comparable aspects of companies' plans in advance of business plan submission streamline the price review process?

(98) Yes. We consider that publishing initial views on botex, common performance commitments and the cost of capital ahead of business plan submission would give procedural benefits.

(99) Providing an early view on botex would help companies to refine their plans by understanding any differences between their forecast of botex costs and those in Ofwat's base models. This would a) help companies to understand what cost adjustment claims they should put forward, and b) provide an early challenge to botex costs ahead of the Initial Assessment of plans. Reflective of the very early stage in the process that the initial view of botex would need to be published, we would expect this to take the form of a range of potential values, alongside a clear intention to refine the assessment as more data and information comes to light in business plans and during the PR24 process.

(100) Similarly, for common performance commitments, there would be merit in publishing indicative levels in advance of business plan publications. Performance commitment levels will inform companies' investment plans and allow them to engage with customers on the likely level of performance they will commit to in their plans (as opposed to proposing performance commitment levels which are subsequently altered during the price review process). As with botex allowances, indicative PCLs should be published as a range at an early stage with final PCLs informed by data which becomes available during the business planning process (e.g. customer engagement evidence).

(101) We consider that publishing an early view of the WaCC was a helpful step in the PR19 process and would welcome early publication in PR24. As with botex and PCLs this should be published as a range with a view to narrowing it down as additional information comes to light during the process.

(102) Timing of these publications is key, as centralising some parameters means that plans are more dependent on when this information becomes available. It will influence the cost and service package proposed in company plans, and companies will need time to consult with customers on the acceptability of plans, taking Ofwat's initial views on botex, PCs and WaCC into account. At PR19, Anglian published its draft business plan for consultation with customers in March 2018 to ensure this engagement informed its plan published in September 2018. Working to a similar timeline, we request that Ofwat's provide its initial view on comparable aspects by January 2023 at the latest.

Question 4.6 Should we adopt a collaborative approach to developing Welsh companies' plans at PR24? If so, how should we go about doing this?

(103) Given the different legislative framework operating in Wales, we consider that this question is best considered by companies operating in Wales and Welsh stakeholders. The approach taken could offer a useful exemplar, the learning from which could be applied to the regulation of English companies at PR29.

Question 4.7 What are your views on how we could provide clarity over the long-term regulatory framework?

(104) The long-term regulatory framework needs to be considered in the round, taking into account the cumulative impacts of Ofwat's overall approach to PR24 and related risks and incentives this puts in place for companies, customers and the environment. This is a significant part of the PR24 approach for which we acknowledge that a lot more work is needed to develop the PR24 strategy further and to understand its longer-term impact.

(105) Future approaches to the incentives framework included within price reviews need to be reflective of previous investment and actions taken to improve service. These will have an impact on the achievability of future PCLs, such as enhancement investment in leakage leading to lower levels of leakage which have a higher maintenance cost.

(106) We are concerned that some of the proposals purported to provide long-term certainty will not deliver the intended outcomes. For example, we believe that applying outperformance payments over time with a delay dependent upon the continued achievement of outcomes being delivered would in fact weaken long-term incentives. Withholding these payments would make return on investment less certain and therefore discourage companies from making these investments. We also consider that the framework could be made more certain by maintaining performance commitments over multiple AMPs under the existing performance payment structure. This would ensure that any rewards earned in one year are returned through underperformance penalties if performance is not maintained. We also consider that the proposal moves away from the principle that rewards and penalties should be paid as close in time as possible to when the performance level was achieved. This more closely reflects the experience in competitive markets.

Question 4.8 Are there barriers to water companies changing how they deliver their core functions to deliver greater environmental and social value? How can we address any barriers?

(107) Delivering greater social and environmental value is dependent upon companies consider placing value on the wider social and environmental impacts of their enhancement investment proposals. Currently, a key barrier to delivering greater environmental and social value is that this value is not reflected in the price review cost assessment process. We support the greater focus that Ofwat is recognising in this document, but to achieve the aim will require these wider value drivers to form part of the assessment of business cases at PR24. This could for example be a part of the optioneering criteria, under which companies would need to demonstrate that they have understood the social and environmental impacts of the options they have considered, beyond the immediate challenges that the investment seeks to address. Our Six Capitals approach to investment decisions that we are deploying within the business for AMP7 may provide a useful template here. This is enabling us to embed social, natural, intellectual, people, manufactured and financial capital into our decision-making criteria for option consideration. We will work with other companies and Ofwat to develop comparable approaches to this with the rest of the industry.

(108) It will also be important that whole life costs are considered where of two (or more) options, one has a lower cost over a 5-year assessment and another has a higher five-year cost but a lower whole life cost. We welcome Ofwat's recognition of this in the document and the recent Green Recovery determination and would like to work further with Ofwat to develop the requirements to capture this information in the PR24 process.

Question 4.9 Do you have any further suggestions for increasing the focus on the long term? If so, what are these?

(109) One suggestion which is not fully explored within the PR24 and Beyond document is whether treating longer-term enhancement investments outside of the 5-year price review process and instead assessing costs through a different process could be beneficial. This may be particularly relevant for large-scale long-term assets such as those being proposed as Strategic Regional Options through the RAPID process. This could then allow a focus within the 5-year price reviews on those parts of companies plans that are more suited to being assessed on a short-medium term basis, e.g. botex cost assessments. We want to work with Ofwat and the sector to develop thinking on these alternatives, how they could complement existing tools and what regulatory tools and protections would need to be considered.

(110) We consider that Ofwat's approach to PR24 could more fully address the distinction between botex and enhancement expenditure. We would like to work with Ofwat and companies to consider whether there are more fundamental changes to their treatment so as to take a more long-term focus.

(111) In its Final Determination, the CMA highlighted that "There may be benefit in Ofwat providing greater clarity upfront around the criteria for deciding that additional funding is appropriate"16. We note that Ofwat has highlighted that it is considering totex modelling which includes both base and enhancement costs to avoid cost assessment being distorted by any allocation between base and enhancement expenditure. However, it is not clear that this will provide clarity on what constitutes base or enhancement and risks reducing the distinction between the two further. Rather than developing a totex modelling approach, we would support the CMA's recommendation to provide clarity upfront on the distinction between enhancement and botex.

(112) Finally, we have two further (more technical) changes that we propose be made to the cost assessment process to increase the focus on the long-term:

- Inclusion of long-term impact as an assessment criterion for cost adjustment claims and enhancement cases. This would help to ensure that companies are considering the long-term impacts of their proposals when developing their plans, and that long-term impacts are front of mind in Ofwat's assessment of company plans.
- Inclusion of net zero as a line in the WS2/WWS2 enhancement tables. This would help to support the evidence base for the costs companies incur in delivering net zero.

[16] https://assets.publishing.service.gov.uk/media/60702370e90e076f5589bb8f/Final_Report_---_web_version_-_CMA.pdf para 5.20

Chapter 5: Getting more for customers, communities and the environment

Key Points

(113) We support the use of incentives both in terms of process and as wider regulation, we note the importance of incentives to drive outperformance which is ultimately in customers' interests. It is arguable that a gradual shift away from RPI-X means incentives to innovate may be dulled as companies retain fewer benefits from outperformance.

(114) As the regulatory framework continues to develop for PR24, Ofwat should undertake further analysis to ensure it is striking an appropriate balance between costs, risk and service improvement and give further consideration to the interplay between the proposed incentives and assess whether, taken as whole, they create a regulatory framework which supports the long term focus and creation of social and environmental value.

(115) Ofwat has indicated it is considering amendments to a range of tools within the regulatory framework and processes to support its ambitions for PR24, for example:

- Consideration of how ODI incentives should apply across multiple Price Review periods;
- Reducing the total number of ODIs;
- Deriving ODI rates for common measures using national research;
- Adoption of "targeted challenges";
- Amendment to Business plan incentives;
- Potential "early certainty" mechanisms for ODIs for good plans;
- Amendments to cost sharing rates, including potential links to asset health performance;
- Potential early company submissions to Ofwat on enhancement and ODI rates;
- Ofwat to provide companies its early view on botex models; and
- Potential removal of the Initial Assessment of plans phase from the overall timetable.

(116) In this submission, we have provided some initial thoughts on these changes "in isolation". Clearly, the overall impact of these amendments, in addition to other areas such as cost assessment and risk and return will need to be assessed as a total framework. We would urge Ofwat to consider the incentives package as a whole and whether it supports the achievement of the long-term goals set out in the document. As recently discussed with Ofwat, we propose to carry out further work in this area over the summer, for submission to the Futures Ideas Lab.

(117) The streamlining that Ofwat is considering is not the same as reducing complexity and may remove a critical step in the process for companies and Ofwat to explore potential opportunities and areas of divergence. We support retaining both the IAP and DD stages separately thereby providing companies with early insight into Ofwat's assessment and allowing sufficient dialogue between companies, Ofwat and wider stakeholders ahead of Draft and Final Determinations. We think this is vital given the likely diversity of companies plans and giving Ofwat the opportunity to gain greater understanding and explanations from companies.

(118) The adoption and development of Purpose-led Companies and Ethical Business Regulation should encourage trust and collaboration in the sector which in turn should lead to simplification of the

regulatory process over time. The adoption of EBR may include recognising where companies have made fundamental irrevocable changes to their formation to provide protection to customers and environment, such as the change we made when we enshrined Purpose in our Articles of Association. This provides a legal duty for all directors of the company and requires us to ensure that we are bringing social and environmental prosperity to the region we serve, whilst ensuring a fair return for our shareholders. In addition to the regulation we face through our various regulators, to ensure we are publicly held to account for delivery against these commitments, we continue to work with a range of stakeholders on a project with the British Standards Institute (BSI) to develop a new standard on sustainable purpose in business which we expect to publish for consultation later this year.

Responses to Individual consultation questions

Question 5.1 Should we undertake an initial assessment of plans at PR24? If so, what areas should we focus on in this assessment?

(119) We support option 3, retaining the IAP and DD as separate stages in the price review assessment.

(120) We welcomed the approach in PR19 for the IAP, however would urge Ofwat to provide greater clarity and transparency on how business plans will be assessed under the IAP in its Final Methodology. With regard to the assessment for the IAP, we ask Ofwat to work with the industry to develop a methodology which takes into account both today's customers and future customers to ensure intergenerational fairness is achieve from business plans, and that the assessment reflects on companies past performance. This transparent approach is in line with EBR. The assessment should be such that what is considered a "high quality plan" should not just equate with does not always mean a "least cost plan", especially when considering whole life costs, focus on the long term and the environmental and social value the plan provides.

(121) Without clear direction as to what information will be provided, and when it would be available this information would be provided in advance of the business plan submission, we do not support merging the IAP and DD. It is important that companies remain able to amend their plans following feedback from Ofwat and sight of other company plans and with the benefit of further customer and stakeholder engagement. This assessment stages provides opportunity for companies to have a greater understanding of what drives value in Ofwat's eyes and thereby can adapt to meet that expectation.

(122) At PR19 companies who were assessed as having produced high quality plans were 'fast tracked' through the process and received, amongst other incentives, early certainty for elements of their plan. This incentive should not be underestimated, and we would encourage Ofwat to consider doing this again, alongside an adjustment to what is considered "high quality", with proposals to give early certainty to cost sharing rates again and ODI rates.

Question 5.2 Should we consider adopting a more light touch approach at PR24 for companies with a strong track record of delivery during the PR19 price review period? If so, what factors should we consider in our assessment and why?

(123) We acknowledge the streamlined process that Fast Track companies received in PR19 and would support a similar approach for PR24 for high quality plans. However, we do not necessarily support the reduced scrutiny being as a result of delivery against the PR19 FD. There is ambiguity against what kind of delivery would be assessed and any incentive adopted needs to be clear in its focus and

how it is obtained. Delivery can mean many things, whether it is delivery through outcomes, cost assessment or other activities such as recognition of activities undertaken to help communities and the environment. For example, the £1m we invested in the Positive Difference Fund and the help we provided to 319,466 people struggling to pay their bill in 2020/21. As a Purpose-led company we strive to bring environmental and social prosperity to our region and this type of delivery could form part of the assessment to become eligible for fast-track status.

(124) If Ofwat focused on delivery against ODI performance or cost assessment performance, on both types of assessment there is weakness as not all data would be available at time of assessment with likely only 3 years of the 5 years of data being available so we would question whether it is representative enough to result in a streamlined assessment. In addition, if plans are judged against previous performance, then the incentive power of the fast track may be reduced as companies who have not performed well may not be as ambitious in their plans as they know they are unlikely to succeed. All companies should be eligible to be fast tracked in PR24 if their plan meets Ofwat's criteria regardless of past performance.

(125) An alternative factor that may enable lighter touch regulation is to recognise that where companies that have embedded social and environmental purpose into their governance arrangements, this provides more up front protection for customers and the environment, helps to deliver and providing public value, and because more of the heavy lifting on these issues is being done in the Boardroom, the regulatory approach can adapt accordingly.

Question 5.3 Should we streamline the price review by combining different steps in the process? If so, which of the three options outlined in this paper should we consider? And are there other options we can usefully consider?

(126) PR19 has previously been described as "peak regulation", with indications that PR24 and beyond should allow for a reduced burden. However, the discussion document offers little promise here, and there is a risk that PR24 misses the opportunity to re-think whether the existing level of complexity creates the clarity and focus in the areas that matter most to enhancing the environment and society.

(127) Streamlining the price review is not about merging stages in a process, but about minimising regulatory complexity and burden, and giving time to focus on longer-term strategic investments required to deliver the ambitions. To support a streamlined process, the industry and Ofwat should aim for transparent and open dialogue which allows companies to engage on specific regional priorities with customers and stakeholders and allows Ofwat to give greater clarity as to its priorities so that there are more opportunities for companies to get it right first time.

(128) One of Ofwat's key themes for PR24 is to reflect a clearer understanding of customers and communities. But removing the stages at which these groups, and other regulators may contribute to the process runs counter to placing weight on the views of customers and communities.

(129) We do not support Ofwat's conclusion that its proposed changes to the PR24 process provide opportunities to companies to build trust with stakeholders. Trust is built by evidencing robust engagement with customers and stakeholders, built on clear evidence of purpose and service delivery. Ofwat's suggestion that fewer bespoke outcomes will deliver this seems counter-intuitive; our experience is that trust will be enhanced when customer and stakeholders can clearly see their priorities reflected in the regulatory design and outcomes. If anything, a regression to more common outcomes risks losing, as opposed to building trust with customers and communities.

(130) The IAP provides an important opportunity for companies to have a dialogue with Ofwat about their initial assessment of companies plans. In addition to dialogue on the assessment of the plans, at the PR19 IAP parts of the methodology were still not finalised, so companies used their response to influence Ofwat's assessment. Examples of this are the benchmarking approach used by Ofwat to assess ODIs and the performance commitment levels for asset health performance commitments and their assessment of growth. At IAP growth was assessed as enhancement before being moved to be assessed in botex plus models at Draft Determination. Therefore, not only is the IAP an important stage for companies to get feedback from Ofwat on its' plan, but also for companies to explore with Ofwat potential policy and approaches which can have significant impacts.

Question 5.4 Is a different approach needed for the initial business plan assessment for companies in England and in Wales?

(131) As stated in question 5.1 we support the retention of the IAP, linked to Ofwat's four themes to clearly set out how these will be used to determine whether companies' plans are high-quality.

Question 5.5 What incentives should we provide for high quality plans at PR24? If we don't make use of early draft determinations, how else might we strengthen incentives to table high quality plans on first submission?

(132) We support the use of effective and consistent regulatory incentives to deliver long-term investment. We agree that incentives should be spread across reputational, procedural and financial and should be there to encourage and reward high quality plans. Transparency is required to ensure that for any incentives available, companies know what they need to do to achieve that incentive.

(133) As noted by the CMA, cost sharing rates should be fixed and not evolve through the process, thereby their strength as an incentive as noted by Ofwat may be limited. We provide more detail on our view of cost sharing rates at question 5.6.

(134) As discussed with Ofwat we will be carrying out further work into incentives over the summer and will submit it to the Futures Ideas Lab.

(135) We note Ofwat suggests the use of directly applicable penalties as Ofgem has done in RIIO-2 however there is a no further detail provided. We would urge caution on the introduction of such measures given the problems experienced within the energy industry.

(136) The penalties applied as Business Plan Incentives have been viewed as disproportionate, unjustified and heavily skewed towards penalty. The assessment criteria were published very late and therefore companies were not given sufficient time to ensure the assessment criteria was addressed in their business plans. If Ofwat were to introduce directly applicable penalties we would ask for early consultation and that the design and the magnitude of the penalties must be proportionate.

Question 5.6 How might we set cost sharing rates at PR24? Should we consider an approach based on our ability to monitor companies' asset health status?

(137) Our view, in line with the CMA, is that cost sharing should be a fixed incentive, rather than used to encourage companies to align with Ofwat's view of costs. In PR19, companies' rates became a function of both initial plans and the revised totex proposals following the Draft Determination. This removes the possibility of cost sharing rates being perceived to penalise companies' plans where they

did not agree with Ofwat's preferred view on scope of activities and related costs. This is important as both companies and Ofwat seek to increase their focus on the long term.

(138) We also think the CMA’s view of differential cost sharing rates for cost categories over which there is less management control (e.g. Business Rates) should be adopted as the starting point for PR24.

(139) We are not clear Ofwat why has singled out asset health as being a priority to link to future cost sharing rates. Also, the industry is still working with Ofwat to developing an agreed framework to measure asset health which is unlikely to be sufficiently robust to enable it to be the measure to inform cost sharing rates.

(140) We believe there is merit in considering different rates for base and enhancement expenditure for PR24. This is something we will consider in our paper on incentives later this summer.

Question 5.7 Which areas should we be considering targeted challenges for at PR24, and why?

(141) We would question the need for targeted challenges given the ability to set challenge through the outcomes framework and requirement to align to the Strategic Priorities Statement. Further, a company with a high-quality plan should be focused on providing social and environmental value in any event so would question the need for additional specified challenges.

(142) However, if Ofwat decides to use targeted challenges, we would suggest targeting areas where there have been sustained high profile failures.

(143) When considering targeted challenges Ofwat should act cognisant of the relationship between these improvements and the costs of doing so. These targets should not be decoupled from a regional cost base for delivery so this would have to be recognised in cost allowances

(144) With regards to water efficiency, the motivation for the challenge is to preserve water and abstract sustainably. Any challenge in this area should consider the outcome to be delivered, whether it is sustainable abstractions, reducing abstraction per capita or other outcomes linked to environmental quality. Focusing on outcomes would allow companies flexibility to the find the best value approach to delivering the outcome (e.g. whether by water efficiency, leakage, alternative supplies etc.).

(145) If targeted challenges are adopted, then early clarity on their scope will be essential.

Question 5.8 Should we use innovation specific incentive mechanisms at PR24? If so what would these be, and what would they add in addition to the other mechanisms outlined in this chapter?

(146) It is important to recognise that innovation does not necessary result in efficiency gains but could result in increases in social and environmental value. Therefore, it is important to consider this when assessing the success of any mechanism adopted.

(147) The innovation fund is still in its infancy and it is too early to decide on its efficacy. Ofwat could consider whether to undertake an independent review of its impact once sufficient time has passed. Until this has happened is it difficult to comment on what other mechanisms may be required.

(148) It could be argued that the current mechanism has created a focus on 'winning' bids thereby any new mechanism that Ofwat considers in the future should encourage a more collaborative approach to foster greater innovation. The development of bids is resource-intensive and the industry will have expended significant resource on the 60+ Innovation in Water Challenge bids and the 30+ Water Breakthrough challenge bids. Ofwat could consider moving to an allowance-based approach at PR24, once innovation capacity has been created and trust and confidence in the incentive established. This approach would be similar to the Network Innovation Allowance which creates a more collaborative environment by default and relies of self-certification of projects, reducing admin burden for both Ofwat and the industry.

Question 5.9 In what ways might we promote the themes of EBR (Ethical Business Regulation) through PR24?

(149) EBR should be embraced by companies and Ofwat in order to build trust in regulation to enable it to be simplified as part of a broader approach to building an overarching narrative for the sector of trust, alignment and collaboration. Under this narrative, EBR should be viewed alongside other sector developments such as the Public Interest Commitment and the development of a BSI standard for sustainable purpose which we expect to publish for consultation later this year. This can enable a long-term focussed regulatory framework which builds trust in the sector.

(150) One way that EBR could be promoted is a collaborative and open approach to the price review process with potential incentives for ethical and purpose led organisations. The challenge will be ensuring it is fair, objective and consistent as possible across companies. One option could be to use a multi capitals assessment to demonstrate public benefit/value and incentivise companies to deliver the greatest value against these capitals. Companies would be free to determine how they can generate the greatest value for their customers, stakeholders and local environment.

(151) A greater focus on public and environmental value in assessing enhancement expenditure as well as the greater focus on long-term value discussed in other chapters also opens the question as to the appropriate method of assessing enhancement expenditure. Given the longer-term delivery and benefit timescales associated with a lot of enhancement schemes, it seems intuitive to assess this in a different way to base allowances.

(152) In the future, consideration could be given to supporting and adopting British Standard PAS 808:2022 Sustainable Purpose: Defining principles for organisational behaviour - Guide on purpose which is to be consulted on this year and launched in spring 2022.

(153) All of the above options could be interwoven into the price review assessment of companies approaches and business plans and enable a more radical change to the approach to regulation that we believe is needed if the long-term ambitions Ofwat has set out are to be met.

Chapter 6 Reflecting customers' preferences

Key Points

(154) In our view one of the key successes in PR19 was the sector's step change improvement in customer engagement. Our approach for PR24 is to build upon this success by making our engagement activities part of an ongoing conversation, set in a long-term context, and not undertaken solely for the price review process. We welcome the opportunity to design and shape this collaborative approach to ensure we continue to build our ongoing relationships with our customers and stakeholders and is grounded in supporting long term ambitions.

(155) The main purpose of conducting customer engagement is to ensure that all of our business decisions are taken with clear customer insight. As part of co-creating this approach we are seeking clarity on how to make the customer voice really count, as the legitimacy of the regime depends on customers and stakeholders being able to clearly identify their role in the process as well as clearly seeing how their views have formulated our plan for PR24 and the longer term.

(156) Our customers put a higher premium on addressing water scarcity and growth than customers in other parts of the UK. Therefore, customer preferences relating to regionally specific issues and local priorities must be adequately reflected, even if they deviate from the national picture. By reflecting local priorities and framing the business plan within the context of our SDS, we will ensure that we do not lose sight of delivering the long-term ambitions as agreed with our customers.

(157) We would like Ofwat to recognise that it is important to understand customer views on options around “the stack” of significant investments needed to tackle long-term challenges. Their views, not only on priorities, but also the options on the pace of investment will be an important factor in developing our business plan.

(158) The legitimacy of customer voice in the development of the business plan will be driven by demonstrating how customer engagement has had an impact at PR24 and beyond. We believe that CCG's play an important role in assuring that engagement processes are rigorous, of high quality and properly reflect the interests of our customers. We will use the removal of the requirement for CCGs as an opportunity to build and shape a forum to engage with a diverse range of stakeholders and ensure that customers and stakeholders have a significant impact the development of our PR24 plan.

(159) Effective timing and clear scope is needed to make this approach work – the national research needs to be complete early enough to allow for regional research to be undertaken to provide the supporting evidence and show where this may deviate from national trends. Regional research will be dependent on national research having been completed so that companies can undertake this effectively. We would like to work collaboratively across the industry, including with Ofwat, to provide some suggested timelines to ensure that we all have what we need when we need it.

Responses to Individual consultation questions

Question 6.1 What are your views on the merits of our proposals for a collaborative approach to standardised and/or nationwide customer research to inform company business plans and our determinations?

(160) In principle, a consistent standardised approach between companies would help to address a number of Ofwat's concerns on the comparability of evidence if the evidence and insight has been generated using a common approach. We believe there is more benefit in seeking to establish common methodological approach than pieces of common research. This would improve the quality of information available to Ofwat and customer challenge groups whilst, critically, seeing companies retain ownership and responsibility for engaging with customers about their specific priorities.

(161) We would like to be involved in the development of the detail, including the alignment to the recent UKWIR 'Options for engagement' study and CCW report on 'Future consumer representation models', to ensure any approach is fit for purpose.

(162) It should be uncontentious that companies' business plan outcome measures and incentive rates should be informed by the views and priorities of their own customers. The legitimacy of the regulatory regime is undermined if customers are not the visible driving force in shaping future plans and priorities. As such a standardised, as opposed to national, methodology is our preferred option.

(163) We would like to understand the scope of the national research to determine if it is focused on ODIs, priorities, acceptability or a combination of factors, as this is currently unclear. This should be communicated clearly as part of the scope and forward plans. At the recent Ofwat workshop we discussed that standardised research could be useful for willingness to pay values and ODI rates, as it can improve comparability across companies, but that the approach must also allow for regional priorities to be reflected in ODI rates and the incentives that companies face, and in optimising investment portfolios. We therefore do not believe that national research can replace the need for company specific research.

(164) The practicalities of reaching an agreement between companies will need careful consideration and consultation. Ofwat should therefore set out how the design, delivery and dissemination of this research will be achievable in time to inform the development of company plans.

(165) There is the risk that any national research could cut across Ofwat's own desire for companies to change customer behaviour locally (customers including stakeholders/ businesses/ developers). For example, if one company changes very successfully and others don't, the views of these different companies will be different and should not be given the same weight in forming all companies' plans. A one size fits all PR24 would be a retrograde step that would disenfranchise customers and stakeholders.

(166) Absent of specific detail on the scope and nature of any central research, we are concerned with Ofwat's expectation of the primacy of any national research. This highlights a need to further understand how central and company-specific research will dovetail as we embark on PR24.

Question 6.2 Do you have any suggestions for how we best implement the collaborative approach to customer research for the price review?

(167) We welcome the opportunity to design and shape the collaborative approach to customer research. We would like to work together across the industry, including with Ofwat, to provide some suggested timelines to ensure that we have what we need when we need it. This will reduce the risk of any research coming out too late and being a hinderance rather than helpful addition to the process.

(168) We would like to request weighting criteria to be developed during the scope and design of the research programme, to ensure fair weighting of all customers (e.g. not just residential) and a balance between national and regional research that reflects individual company priorities.

(169) We would also like to be involved in identifying how and in what areas customers can give most meaningful views. This should be based on asking customers how they want to get involved and what matters most to them, rather than assuming this is already known.

(170) The output of the collaborative research needs to be available to allow sufficient time for companies to use it in business planning (e.g. investment optimisation) and to understand the implications for outcome delivery incentive rates. We suggest that the scope for standardised/ national/ regional research needs to be decided by the beginning of 2022 so that its outputs, alongside Ofwat's view of research requirements can be factored into our programme planning.

(171) It is important to make sure that with any approach, customers feel that engagement is a worthwhile investment of their time. Companies also need to be able to adequately demonstrate that they are acting on engagement they have had with their customers and have tailored plans accordingly. This would be difficult if the research used is only at a national and not regional level

Question 6.3 Are there aspects of negotiated settlements that could be reflected in our price review framework?

(172) Negotiated settlements are a helpful potential mechanism for the development of certain aspects of companies' plans and we would support their use in PR24.

(173) We are encouraged that Ofwat remains interested in the potential benefits of negotiated settlement approaches and how this may be usefully reflected in the Price review process and which areas of companies' plans may most suitably explore this area. We intend to explore this with our Customer Engagement Forum in due course.

Question 6.4 What are your views on our proposals for customer challenge of business plans and assurance of customer engagement?

(174) We believe there are a number of risks to the approach proposed, including:

- A perceived diminution in companies' ownership of the relationship with customers and responsibility for ensuring their views are expressly captured in companies' plans.
- Reputational risk with customers by not seeing us as being innovative & creative. If everyone adopts the same approach this will stifle competitive ambition and innovation.
- Customers may also assume that their views are less reflected in our plans than before. Steps must be taken to mitigate this.

- We would also need to ensure that stakeholders remain engaged and positive throughout the whole process – currently this focus is mainly on customers.

(175) We will retain our CCG as we believe it provides a valuable independent and external forum which has helped to improve the quality of our customer and stakeholder engagement and to test how faithfully we are reflecting the engagement outcomes in our business plans. We believe this remains important and will work with our CCG to continue to ensure robust challenge and assurance.

Question 6.5 What are your views on whether we should develop minimum standards or provide guidance in other areas?

(176) Overall, the provision of developing guidance and developing common approaches across companies helpful as long as the focus is on the 'what' are we trying to achieve (e.g. its purpose) and not 'how' do we achieve it (e.g. engagement methods which would stifle creative approaches). This will ensure any research is proportionate, targeted and relevant.

(177) In the current draft document, the proposed minimum standards do not add any value to the work already undertaken.

Question 6.6 How well does our proposed approach to customer engagement take appropriate account of the different regulatory frameworks in England and Wales?

(178) A wider use of negotiated settlements could be taken forward in Wales in PR24, with lessons learnt collated and shared with a larger roll out considered for future price reviews.

Chapter 7 Planning together for PR24

Key Points

(179) Ofwat's PR24 focus on seeking to bring a long-term planning focus and alignment with price reviews is welcome albeit not unique given previous efforts seeking similar alignment between price review periods and wider strategic planning frameworks such as WRMPs and River Basin Management Plans. For PR24 to deliver differently, there needs to be demonstrable evidence this will impact on the conduct of PR24 and future reviews.

(180) We have a strong track record of planning for the future. In 2017 we refreshed our Strategic Direction Statement which formed the long-term framing for our strategic plans and our PR19 business plan. As well as developing a Water Resources Management Plan (WRMP) we were the first company to complete a Water Recycling Long Term Plan (WRLTP),[17] a forerunner for the Drainage and Wastewater Management Plans (DWMP).

(181) Translating these strategic plans into the five-year business plans is a corner stone of business planning. This is the approach we adopted at PR19 and are building on for PR24, by appointing a new Head of Strategic Resources and a Head of Strategic Growth, with our Director of Strategy and Regulation chairing a Future Resources Steering group that brings all of the long term planning together within our governance structure. We welcome the increased emphasis Ofwat is placing on long term planning as this complements our own achievements and future aspirations in this space. As part of this emphasis we believe further thinking is needed on how investment need established by the DWMP will be integrated into cost assessment at PR24, this could include principles such as focusing on efficiency rather than need during the PR24 assessment.

(182) We do not believe that there is a compelling case for the introduction of a national challenge panel. The combination of the introduction of such a panel and the shift to an emphasis on centrally conducted National Research risks creating a significant disjunct between companies' regional engagement and this panel. This could hamper the development of business plans that are responsive to a regionally specific long term context and the particular preferences of customers.

Responses to Individual consultation questions

Question 7.1 How can we ensure that companies bring together the outputs of the strategic planning frameworks in the most coherent and effective way for business plans?

(183) The emphasis on the long term and how 5-year business plans should be stepping stones toward the achievement of delivering long term outcomes for customers and the environment fully accords with the approach we have maintained over the last 15 years. We first published our Strategic Direction Statement (SDS) in 2007, and then refreshed it in 2017 after extensive collaboration and consultation with our customers and stakeholders. The SDS sets out our four long term ambitions in response to the challenges facing our region. Our SDS formed the backdrop for our PR19 business plan and will do so again for PR24. Ofwat's *PR24 and beyond* document essentially suggests all companies adopt a similar approach for PR24. We believe this is a sensible approach given the scale of challenges the country as a whole faces.

[17] https://www.anglianwater.co.uk/about-us/our-strategies-and-plans/water-recycling-long-term-plan/

The four strategic goals of our 25 year Strategic Direction Statement

(184) As well as developing our Water Resources Management Plan (WRMP) in advance of PR19, we were the first company to complete a Water Recycling Long Term Plan (WRLTP),[18] a trail blazer for the Drainage and Wastewater Management Plan (DWMP). We believe this approach is the optimal one and are encouraged by Ofwat's aspirations to take this forward for the sector.

(185) We welcome the shift in emphasis for companies to consider different long-term aspects of resource needs across their businesses specifically around integrating and aligning long term planning strategic frameworks such as WRMP, DWMP and WINEP. This emphasis on alignment and longer-term thinking accords with our own views. We have made changes within our organisation to enable a greater focus on this, to ensure we develop these plans in concert rather than in isolation. Given the range of investment pressures facing the sector, and the need to ensure that we can deliver these whilst minimising pressure on customer bills, it is ever more important to leave no stone unturned in realising synergies between these long-term plans. This also aligns with the work the sector is doing in setting its 2050 vision and delivering its Public Interest Commitments.

(186) We welcome the increased emphasis Ofwat is placing on long term planning as this compliments our historic approach and future aspirations in this space. As part of this emphasis we believe further thinking is needed on how investment need established by the DWMP will be integrated into cost assessment at PR24. We also note that for strategic schemes developed through the RAPID process, we do not believe PR24 should be an opportunity to revisit the RAPID gateways if achieved.

(187) We believe that companies should use their PR24 business plan to demonstrate that the 5-year plan delivering multi-AMP ambitions aligns with longer term plans. Were this to form part of the PR24 cost assessment process, it would avoid situations where a plan is put forward which may appear to be low cost for one AMP, but delays a significant amount of investment to future AMPs and means that whole-life costs are greater.

(188) Long-term ambitions and broader public value delivered by company plans could be assessed through qualitative aspects of business plan assessment, such as cost adjustment claim and enhancement assessment criteria. This could be through a specific assessment criterion allowing companies to set out the additional value added by an investment and how these have been

[18] https://www.anglianwater.co.uk/about-us/our-strategies-and-plans/water-recycling-long-term-plan/

evaluated. It could also be assessed through the optioneering assessment criterion, through which companies would demonstrate how they have assessed the broader benefits of the different potential investments and could show their wider benefits and how companies have taken these into account within the optioneering process.

(189) There may be a place for Ofwat to issue some guidance in this area to companies. At the highest level, Strategic Direction Statements or similar may help the industry frame and align their long-term challenges, strategic plans and business plan. Another more detailed area is the treatment of growth forecasts developed in strategic plans, how these should be reflected in business plans and the relevant regulatory treatment both ex ante and ex post. An expectation for appropriate cost assessment approaches that recognise long-term challenges should ensure strategic plans are appropriately reflected in business plans.

Question 7.2 What are your views of our thinking on our and companies' roles in engaging with other regulators between business plan submission and our issuing of the final determinations?

(190) Continued iterative engagement with all regulators, to create effective business plans will be imperative to align expectations for both shorter and longer term objectives. This will also help to explore trade-offs between the scale and pace of potential investments across a range of drivers. Ofwat should engage early in the WRMP, DWMP and WINEP processes in addition to understand the longer-term drinking water quality priorities.

(191) We believe there is a risk that a follow-up round of engagement with the other regulators centrally could override the outcomes of bilateral, local engagement with those regulators or indeed investment need and optioneering established through strategic planning processes. We believe it is best for companies to own this engagement. Any additional engagement should not impact the wider price review timetable and should take account of the capacity constraints faced by all stakeholders.

Question 7.3 How could we best involve a 'PR24 Challenge Panel' in the price review process to help ensure that our decisions best reflect the interests of customers, communities and the environment?

(192) We do not believe that there is a compelling case for the introduction of a national challenge panel. The combination of the introduction of such a panel and the shift to an emphasis on centrally conducted National Research risks creating a significant disjunct between companies' regional engagement and this panel which would run against the development of business plans in the long-term context and challenging us facing each specific companies and their customers' views.

Chapter 8 Design and implementation of price controls

Key Points

(193) In general, Ofwat's chapter on the design of future price controls fails to provide a clear evidence base or detail to underpin some of the proposed changes. Therefore, we have found it challenging to respond to these proposals in full, absent of this detail, and we look forward to further engagement around Ofwat's further PR24 development.

(194) We are supportive of the continued development of water resources markets, for example through our development of the Watersource platform. However, such markets are at an early stage of development. It appears that the main barriers to trading are not associated with the water resources control; environmental and drinking quality regulations are rightly requiring a cautious approach and the introduction of new sources of water need to maintain the 'source to tap' approach that underlines drinking water quality.

(195) We also answer the questions contained in the Appendix in this chapter. Amending the boundary to include raw water distribution would not significantly affect the control for Anglian. However, extending the boundary to include water treatment would be counter-productive. Although it could provide comparability with significant new water resources options, it could present a barrier to market entry, for example by averaging costs over existing price controls as well as geographically.

(196) Most materially, the proposed change to Water Resources price control boundary is presented without with any clear reason for change. This is inappropriate, given the material change in exposure of existing RCV to market risk. Nor is it clear how this directly aids the delivery of the key themes identified for PR24, in fact, it could frustrate them.

(197) The change to the design of the retail price control is also without any detail as to how this would be constructed in practice. We would also encourage Ofwat to revisit aspects of the price controls, for example the lack of indexation of the retail price control in the construction of PR24.

(198) We welcome Ofwat's continued focus and discussion of the approach to Developer Services given the link to facilitating timely investment to deliver sustainable housing and economic growth. We advocate reviewing the treatment of different growth-driven investments, noting the distinction between "on-site" and more strategic growth investment requirements and that which is driven by population growth that often occurs even if housing growth is slower than expected.

Responses to Individual consultation questions

(199) In this section we respond to the questions posed both in Chapter 8 and the Water Resource specific appendix.

Question 8.1 Do you agree with, or have any comments on, our general approach to the design and implementation of controls, i.e. to retain separate controls with the same broad structure as at PR19, but with improvements to our implementation?

(200) We support improvements that will deliver better outcomes for customers, communities and the environment, specifically welcoming changes that will enable better comparison of costs and to drive innovation and resilience.

(201) However, any proposed approach to the structure and design of future price controls needs to be informed by a clear view from Ofwat as to how this will achieve the wider, longer term goals of the sector, which the discussion document did not provide.

(202) In general, we have therefore found it challenging to respond to these proposals in full, absent of the detailed reasons for them. We look forward to further engagement on these as part of Ofwat's further PR24 development.

Question 8.2 Do you agree with, or have any comments on, our proposals for specific parts of the value chain, i.e. for water resources, developer services, residential retail and business retail in Wales?

Please note that specific questions related to a) the structure and boundary definition of the water resources control are set out in a separate appendix; and b) our review of the bioresources market are set out in a separate consultation document.

Developer services and growth

(203) The commitment to improve cost assessment for developer services activities is critical in both the development of the market for development services and equally as important, the facilitation of investment to deliver the infrastructure needed to enable efficient, sustainable growth.

(204) The approach to assessment of growth-driven costs and development services shifted substantially during the extended PR19 process. This included both the approach to cost assessment and the timing of cost recovery. As we are now in the design and development phase of PR24, we have an opportunity to take stock and set out improved processes and data capture to enable a more robust approach to cost assessment. As Ofwat are aware, as a high growth region, we have spent a significant amount of time in review approaches to this challenge and would like to spend time with the Ofwat team exploring alternative approaches.

(205) We continue to believe that it would be most appropriate to model growth expenditure separately from base expenditure. We also recognise to enable a focus on the long term it may be necessary to separate the more routine, repeatable aspects of enabling growth (such as connections activity) from strategy investment which will benefit both current and future customers. This is consistent with Ofwat's emphasis on the long-term.

(206) For example, on-site activity (largely the activities proposed by Ofwat for de-regulation) could be modelled using a relatively simple cost modelling approach. This would give greater robustness to the associated relative efficiency assessment for this type of activity, both for companies and the competitors in this market.

(207) By contrast, the drivers of investment in network reinforcement and treatment upgrades are complex and not linked 1:1 with volume of connections. It is also efficient to develop and construct strategic infrastructure to enable developments both in the shorter and long term, many of which we have on the horizon the Anglian region. Historically, our Wing Strategic Main is an example of this infrastructure and also the challenges the 5-year regulatory framework has in dealing with investment of this nature. It is vital that Ofwat improve data capture and cost assessment for these activities, not just on-site developer services activity.

(208) Looking forward, growth drivers such as the Cam-Ox Arc will drive the need for efficiently delivered infrastructure benefiting multiple future developments. We are not the only region which is subject to high growth and the need for strategic infrastructure.

(209) The PR24 development phase provides an opportunity to consider a different approach to PR24. We remain of the belief that they should be assessed separately, in a similar way to other areas of enhancement expenditure. We are currently leading a WaterUK group of companies to considering this topic in detail and will work with Ofwat to share both this work and our previous thinking in PR19 to explore alternatives for PR24.

(210) As we and Ofwat are aware, the timing and certainty of growth demand drivers is uncertain. For PR24 we want to avoid protracted debates on whether companies', Ofwat's, Local Authorities, or the Office for National Statistics (ONS) forecasts for the next 5-years are "correct". We know with certainty none of these forecasts will be perfectly able to predict growth. This doesn't diminish their value in helping to shape forecasts and will remain central to longer term strategic planning such as WRMP and DWMP. However, against this backdrop it requires mature engagement to develop robust approaches to cost assessment, cost recovery and volumes which enable timely investment balancing the risks faced by companies and current and future customers in terms of cost and service.

(211) To that end, we consider there is likely merit in some form of mechanism for "truing up" growth expenditure and volumes for PR24. The post-CMA DSRA provides a starting point for exploring a future mechanism.

(212) As recognised by the CMA in its redetermination, new development and population growth drives wider costs than just those associated with new connections on development sites. Because growth is beyond company control, and therefore so are these wider costs, reconciliation mechanisms that reflect the drivers of all growth costs, including network reinforcement, strategic investment and upgraded treatment works, is appropriate for an efficient allocation of risk between companies and customers. We believe that disaggregation of new connection drivers and wider strategic growth drivers will help with both cost assessment and the allocation of risk through reconciliation mechanisms and customer protection mechanisms for strategic infrastructure.

(213) Regarding regulatory treatment, we understand the merits and agree with the proposed scope under the option for deregulation. We welcome further consideration of this option. However, we note that this leaves network reinforcement and treatment costs associated with growth, as well as revenue from infrastructure charges, within the price control so a requirement for a reconciliation mechanism would remain. This mechanism should account for cost and revenues.

Bioresources

(214) We have responded separately to Ofwat's consultation on the bioresources market. We are broadly content with most of the proposals in the consultation and will support their implementation.

(215) We have found the proposal on a different approach to determining bioresources difficult to assess. We are not sure we have fully understood the details of Ofwat's proposed option nor identified all of the potential implications so are unable to support at this stage. Given the potential consequences of changing the basis of determining the allowed revenue and the number of design and implementation issues which the consultation we would propose further discussions on this before a decision on this proposal is made.

Question 8.3 Do you agree with, or have any comments on, our proposals spanning multiple parts of the value chain, i.e. for major projects and future reconciliations?

(216) We focus our comments on Ofwat's major projects proposals and reflect on our experiences of the DPC process where Anglian is one of only three companies currently engaged in a DPC project, working closely with Ofwat to develop and learn from these first projects in the water sector.

(217) Our thoughts on the initial Ofwat proposals on major projects are set out below:

Enhance our view of long-term projects

(218) We are an active participant in the discussions shaping the RAPID process across the industry and with Ofwat. Allowing major projects to be brought forward at any time could be a beneficial approach to the timing of major projects across the sector. This accords with our view that there should be a change to how enhancement expenditure is treated at PR24, which will remove the constraints of a 5-year regulatory settlement approach and help to realise the long-term focus set out in the discussion document.

(219) Consideration needs to be given as to how the WRMP, DWMP, WINEP and Price Review processes can work more effectively together to determine the need for projects, effective option appraisal, strong customer support, rigorous cost assessment and which schemes may be suitable for DPC. These processes should be carried out once, not multiple times. If this could be done, it could also help the development of markets with greater visibility of a pipeline of schemes and the opportunity for quality regulators to have early site of potential investments and flag any regulatory, legislative or commercial risks that would need to be addressed.

Improve incentives to incumbents to engage with DPC

(220) We welcome Ofwat's recognition that the current framework disincentives companies to engage with DPC. This is a function of the current framework being more heavily weighted towards penalising companies rather than rewarding them. We agree and have shared views with the Ofwat team as part of our current DPC engagement.

(221) We look forward to hearing Ofwat's proposals on this and recommend that Ofwat ensures that the scale of the potential reward is balanced with the risk appointees are exposed to as procurement bodies and contract counterparties.

(222) We would encourage Ofwat to reflect on whether any additional incentives of the nature of those being suggested for future PR24 DPC schemes and participants should be applied to existing DPC schemes.

(223) Reflecting on the PR19 DPC process and interactions within the Outcomes framework, we would recommend that any future customer protection, as is the case in the current DPC ODI, is clearer in its calibration. For example, the existing Anglian over and under performance ODI in relation to DPC is applied on the basis of timing and quality of control point submissions. Ofwat has not provided any further guidance about how the incentive rate will be calculated, what criteria will be used to assess it or what the weighting between timely delivery and quality are. For future schemes and DPC engagement, explicit guidance in this area will make the incentive more effective by providing clarity around the cost/benefit trade-off for the appointee.

Reduce transactions costs through standardisation

(224) As one of the companies currently engaged in a live DPC process, we agree that the current DPC framework provides limited guidance to appointees when designing the contract or procurement process. This allows a lot of flexibility for companies to develop bespoke arrangements. Some standardisation could lead to more efficient pre-tender, tender and bidder costs but in all cases the incumbent will need to ensure its specific risk exposure is recognised and properly priced in any contract it enters into. We welcome the opportunity to work with Ofwat to identify areas where additional guidance would be beneficial.

Investigate the further award of project licences

(225) We welcome Ofwat's intention to explore the use of SIPR and DPC as delivery models for major projects. Both have benefits and drawbacks and we will support Ofwat's exploration of how to derive the decision framework and the process for determining suitability for DPC vs SIPR and how this interacts with the existing eligibility framework.

Treatment of shared assets, risks and outcomes

(226) Multi-party, multi beneficiary decision making and investment could generate significant benefits for wider communities beyond water customers. Naturally, this introduces complexity into the funding and management model for the projects. We believe there is an imperative to remove all barriers, including regulatory ones to ensure best value solutions are designed and delivered. Anglian will continue to engage with RAPID and Ofwat to help explore these evolving approaches and build on the recent Green Recovery processes.

Future reconciliations

(227) We support Ofwat reviewing the future role and complexity of the suite of reconciliations underpinning Price controls. We have previously highlighted the growing complexity of this area. Any changes to these reconciliations need to consider the consequences for the balance of risk between companies and customers.

(228) Absent from the discussion is how Ofwat will develop a longer-term view of reconciliations and how this develop alongside other reforms to the regulatory framework – for example how different approaches to the treatment of enhancement expenditure may require an evolution of reconciliation mechanisms supporting these in the longer term beyond the 5-year price control.

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

Question 14.1 How can costs and incentives for the existing water resources control be targeted more effectively?

(229) The water resources price control is relatively new and the experience of this now developing. This is also true of the upstream water resources market.

(230) We continue to be supportive of this market: as well as publishing and refreshing Market Information data, our Bid Assessment Framework, and the Network Access Code, we have worked to improve the accessibility of market data, through the Watersource Market Information Platform. Furthermore, we have worked with other licence holders and the Environment Agency in the creation of the Watersource Water Trade platform. There are promising signs in these markets, but they are at an early stage and barriers beyond information remain. As such we are working with Water Resources East as part of the EU Interreg Water for Tomorrow project, which is piloting catchment abstraction management and trading, supported by new catchment management system tools and

techniques. In summary, more time is required for the water resources market to develop into an effective price control, and for the lessons learnt from this to be reviewed.

(231) The consultation refers to water resources potentially being viewed as a 'separate company'. However, it is important to recognise that the price control is only one driver in organisational management and structure. We have ring-fenced aspects of the upstream water resources market, such as bid assessment and associated scrutiny. However, in 2020 we brought our Water Resources team into the Water Business Stream, supporting the 'source to tap' approach promoted by the Drinking Water Inspectorate. This also enables a closer link between abstraction management and operations, which is vital for abstraction compliance, as well as the seamless integration of new water resources infrastructure, such as our interconnectors.

Question 14.2 Would amending the boundary to include raw water distribution or to extend it further to include water treatment improve the operation of the control? What are the issues involved?

(232) It is not immediately obvious what amending the boundary is seeking to achieve e.g. cost allocation / botex modelling improvements, market functionality or integration of longer-term future investments (e.g. associated with Strategic Regional Options). Improving market functionality has been discussed in the answer to Q14.1. Including water treatment may support adoption of SROs, but several barriers to this remain including DWI concerns with third party operators of treatment facilities.

(233) Most materially, the proposed change to Water Resources price control boundary is presented without with a clear compelling reason for change given the material change in exposure of existing RCV to market risk, or how this directly aids the delivery of the key themes identified for PR24.

(234) The change to the design of the retail price control is without any detail as to how this would be constructed in practice. We would also encourage Ofwat to revisit, aspects of the price controls, for example the lack of indexation of the retail price control in the construction of PR24

(235) The current split between water resources and raw water distribution creates issues with data as in some cases it is difficult to define the boundary between them due to the integrated nature of our operating systems. Furthermore, unlike some other companies, we have limited raw water transport assets (largely associated with reservoir intakes) so moving the boundary would be straight-forward. In addition, it is highly unlikely that extensive new raw water assets will be constructed due to concerns over invasive non-native species and the potential need for preliminary treatment. In summary, we see benefits in joining the water resources and raw water distribution price controls, although the full benefits can only be realised by addressing issues associated with market functionality.

(236) However, we would have concerns about moving the boundary to include treatment assets. There is no simple relationship between the availability and cost of raw water and its subsequent treatment. For example, although groundwater is generally a cheap source of water, it can often require nitrate removal or blending. Furthermore, groundwater treatment works tend to be much smaller and therefore there are limited economies of scale. Having a widely drawn price control boundary has the potential to produce a unit cost of treated water that is meaningless when compared to the actual, local costs. This may actually limit entry to the market, when local options are compared to averaged costs, especially if these are regionally averaged.

(237) Note that we would still be expecting to report under the RAG by the individual components as this allows for better allocation and understanding of costs.

Chapter 9: Outcomes

Key Points

(238) We are long-term advocates of an outcomes regime and believe this has helped to deliver benefits to customers and the environment. A drive to focus on outcomes rather than outputs is consistent with the sector's long-term view and the recognition is that the destination is more important than the prescriptive path taken. Drought resilience and achieving Net Zero are two examples of these long-term outcomes.

(239) Over successive price reviews companies have engaged with their customers and stakeholders in the development of their proposed outcomes, performance commitments and incentives based on detailed customer engagement representative of customers' views on their service priorities. We retain a sense of pride that this was recognised as a strength for Anglian in how we engaged with customers on outcomes, and their reflection in our PR19 proposals.[19] Any approaches in PR24 and subsequent reviews must ensure incentives to do this well are not diminished.

(240) There is an opportunity for Ofwat to set an incentive regime that facilitates greater creation of environmental and social value consistent with its stated goals for PR24. By placing emphasis on purpose-led business and acting consistently with the principles of ethical business regulation this would align with the sector's long-term ambitions and goals.[20] There may also be the potential to use six capital frameworks to incentivise the creation of value, allowing companies the flexibility to find the best places to create that value. Ofwat are actively considering this which we support.

(241) Ofwat's direction in the PR24 and beyond document is to rationalise the overall number of measures which bear weight in the PR24 outcomes regime. This is driven by the desire to ensure consistency of approach and incentives across the sector. As set out in other chapters, Ofwat's proposal for standardised research on common measures could support this consistency if well designed, collaborative and implemented in a timely manner. We expect this to be the case, but further detail on scope and timetabling needs to be agreed.

(242) Common outcome measures do not equate to common regional expectations on levels of service, common future aspirations for improvement nor common costs to improve services provided in future. Future approaches must avoid diluting the clear views and regional preferences of customers, nor lose ownership of creation of the portfolio of outcomes that potential centralisation of the common measures and outcome delivery incentives (ODIs) could bring. There is a strong risk that this rationalisation only benefits the simplification of Ofwat's assessment of Business Plans in the short term, rather than driving the representation of customers' longer-term views. Companies and Ofwat must work together to ensure this is not the case.

(243) Ofwat's references to social and environmental value aligns with our Purpose and supports incentives that encourage the industry to deliver the greatest value for customers and the environment in England and Wales. We and other companies proposed a range of outcomes seeking to capture this in PR19; the opportunity to continue to promote such measures should not be diminished in PR24 for the sake of comparability.

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[19] PR19 initial assessment of business plans: Summary of test area assessment, figure 6.1

[20] For example the industry public interest commitments https://www.water.org.uk/wp-content/uploads/2019/04/Public-Interest-Commitment.pdf

(244) We believe PR24 represents an opportunity to focus in on the most important broad outcomes. There may be opportunities to widen focus beyond important intermediary measures, such as leakage and PCC, to broader, more holistic outcomes such as reducing abstraction per capita and to focus incentives on these.

(245) As stated elsewhere in this response, early clarity around the interaction between base costs, enhancement costs and the outcomes framework is essential. Clearly companies should be appropriately funded to meet the level of performance supported by their customers. We retain our previous concerns on how using base cost can effectively set future levels of service for all measures. This may be appropriate for some measures where performance is to be maintained, but is unlikely to effectively capture the regional specific costs of further improvements. This was evidenced through the recent CMA redeterminations which demonstrated materially different cost profiles associated with different levels of, and changes in, leakage performance.[21]

(246) We understand Ofwat's desire for greater consistency in customer research for common measures at PR24. We believe the best approach is standardisation of regional research, rather than a national study. Standardisation would remove the methodological concerns held by Ofwat at PR19 while ensuring regional customers views are used to prioritise investment programmes and reflected in company ODI rates. It would also place the industry in control of the timetable for this work and allow alignment between values used to optimise investments and set ODI rates.

(247) We recognise the potential benefits of early visibility of base cost models, PCLs and outcome delivery incentives. We believe that the benefits of early sight of these would outweigh any concerns Ofwat have around potential perverse incentives in providing this information ahead of business plan submissions. This would also enable companies to complement this with any specific regional evidence. The timing of release of this information, if it is to be procedurally useful, is important. To aid Business Plan development, this must be made available by January 2023 at the latest.

Responses to Individual consultation questions

Question 9.1 What kinds of performance commitments should we include in the price review? What outcomes require financial incentives for all companies for the foreseeable future?

(248) Ofwat's direction in the PR24 and beyond document is to rationalise the overall number of measures which bear weight in the PR24 outcomes regime. We recognise this is driven by the need to ensure consistency of approach and incentives across the sector. As set out in other chapters, Ofwat's proposal for standardised research on common measures can support this consistency if well designed and implemented, but this must include giving weight to well-evidenced company-level customer engagement outcomes.

(249) When selecting appropriate outcomes to incentivise, a useful starting point could be to agree criteria against which potential outcomes are assessed. Outcomes and incentives will only be effective if appropriately targeted and selected. They must be important measures and to influence behaviours, they must be clear and controllable. We believe fundamental criteria for outcome selection are whether the measure is:

- important and deliver value for customers or the environment,
- clear, understandable and measurable,

[21] CMA redetermination, paragraph 8.77a.

- directly in water company control.

(250) Discussions in Ofwat's Outcomes Working Group on 22 July 2021 touched on the possibility of linking environmental incentives to the Water Framework Directive status. We believe further thought is necessary as to the suitability of such an approach, as generally water companies are only one of a number of contributors to WFD status so parameters may not be wholly controllable by the industry or could incentivise reductions in certain parameters (e.g. phosphorous) that do not lead to appreciable ecological improvement.

(251) Common measures do not equate to common levels of service, common future aspirations for improvement nor common costs to improve service in future. Future approaches must caution against diluting the clear views and regional preferences of customers, nor lose ownership of creation of a tailored portfolio of outcomes that potential centralisation of the common measures and outcome delivery incentives (ODIs) could bring. There is a strong risk that this rationalisation only benefits Ofwat's assessment of Business Plans, rather than ensures true representation of customers' views.

(252) We see Ofwat's focus on social and environmental value as having strong alignment to our company's purpose and support incentives that encourage the industry to deliver the greatest value for customers and the environment in England and Wales. We believe PR24 represents an opportunity to focus in on the most important outcomes.

(253) There is an opportunity for Ofwat to set an incentive regime that facilitates greater creation of environmental and social value consistent with its stated goals for PR24. By placing emphasis on purpose-led business and acting consistently with the principles of ethical business regulation this would align with the sectors' long-term ambitions and goals.[22] Establishing a clear, consistent framework could aid comparability. There may also be the potential to use six capital frameworks to incentivise the creation of value, allowing companies the flexibility to find the best places to create that value.

(254) The sector should explore opportunities to broaden focus beyond important intermediary measures, such as leakage and PCC, to more holistic outcomes such as reducing abstraction, improving environmental quality and promoting water efficiency across the value chain, and incentivising these broader outcomes through the regulatory process.[23] An example of the use of broad outcomes is Yarra Valley Water in Australia, where drought conditions can become extreme. That being said, an important place remains for some bespoke performance commitments that reflect regional challenges and customer priorities. This is one of the avenues through which companies can set regionally focused incentives to deliver environmental and social value, in line with Ofwat's principles for public value in the water sector.

Case study: water availability and conservation

The outcomes framework could align incentives to find the most efficient ways of delivering holistic outcomes. For example the best value places to save water, which could be raw water leakage, treatment losses, customer consumption or treated water leakage. This is the approach adopted by some water companies in water scarce parts of Australia, such as Yarra Valley Water. [24]

[22] For example the industry public interest commitments https://www.water.org.uk/wp-content/uploads/2019/04/Public-Interest-Commitment.pdf

[23] This could build on the existing water quantity metric in our Natural Capital Impact performance commitment. See section 1.2.24 https://www.ofwat.gov.uk/wp-content/uploads/2019/12/PR19-final-determinations-Anglian-Water-%E2%80%93-Outcomes-performance-commitment-appendix.pdf

[24] See water availability and conservation outcome https://www.yvw.com.au/performance2020

Yarra Valley Water's business plan for 2018 – 2023 focuses seven outcomes with associated lead measures and financial incentives. These are:

1. Safe drinking water
2. Timely response and restoration
3. Fair access and assistance for all
4. Modern flexible service
5. Care for and protect the environment
6. Reliable water and sewerage services
7. Water availability and conservation

The water availability and conservation outcome is supported by a lead measure of 'total water usage' expressed as litres/ per person/ per day to reflect the intent of the outcome and customer sentiment as it takes into account leakage and usage by all customer segments. Yarra Valley Water targeted a 5.8% reduction in this measure in the period. The outcome is supported by the following indicators:

- Household drinking water usage (litres/ per person/ per day)
- Metered volume of recycled water delivered to customers (megalitres)
- Percentage of non-revenue water
- Infrastructure Leakage Index

Asset Health

(255) Asset health underpins delivery of other valuable long-term outcomes. The current asset health performance commitments, for example sewer collapses, are shorter term in scope and focus on asset failure.

(256) There are some existing performance commitments that do not incentivise the best outcomes for customers. In particular, the unplanned outages performance commitment incentivises a focus on individual asset resilience rather than systems resilience. Over a number of years, we have invested in interconnection to reduce the percentage of our customers supplied by a single supply system to improve resilience. We believe it would be better for Ofwat to incentivise companies to reduce risk to customers, e.g. through water supply interruptions, rather than focus on the resilience of individual assets.

(257) We would propose that Ofwat build on the outputs of the UKWIR Future Asset Planning[25] project which will identify key indicators of asset health to illustrate current asset condition and long term trends.

Question 9.2 How do you think we should monitor outputs that are not clearly linked to the outcomes incentivised in the price control? Would it help to distinguish between PCs that monitor outcomes and PCDs that monitor outputs? What other options could we consider?

(258) PR19 utilised the Outcomes framework for monitoring delivery of some significant programmes of work which contributed to long term outcomes for customers and the environment. Examples from our outcome PCLs relate to the delivery of our smart meter programme, strategic interconnector programme and the WINEP programme. These all contribute to delivery of our long term ambitions set out in our SDS. In essence, the PR24 proposal is an extension of this approach under a revised definition of PCD. We would support this change, to avoid confusion.

[25] https://ukwir.org/ukwir-appoints-atkins-to-lead-future-asset-planning-research-programme

(259) We believe there is still scope for the mechanism, outside of the performance commitments, to incentivise delivery of targeted outcomes linked to long-term plans. For example, enhancement funding for treatment works improvement could have a mechanism that focuses on delivering the intended outcome of improved river water quality rather than the output of building an extension to the works. Considering potential outcomes should remain the default as these should be the divers of activity, but we agree these more targeted mechanisms should sit outside of the performance commitment framework.

(260) We believe that in some circumstances these mechanisms could be symmetrical. For example a mechanism tied to a metering programme could return funding if not all meters are delivered, but also incentivise faster delivery i.e. provide additional funding in period if more meters are delivered. This would improve flexibility in the price control regime and allow companies to react and adapt their plans. It would also incentivise faster, efficient deliver of investment spanning multiple AMP period which can benefit customers and the environment sooner and help achieve these longer term ambitions.

(261) The detail of these mechanisms should be informed by the approaches to long-term enhancement investment, whereby longer term outcomes or outputs could be linked to multi-AMP investments.

(262) There is a risk that this proposal would run counter to the principle of focusing and simplifying the price review process. This mechanism should not seek to capture all elements of enhancement funding, but should be proportionate and targeted to the most material areas which would reduce the risk of excessive complexity. There is a risk that a plethora of mechanisms undoes any benefits delivered by rationalising the number of outcomes and performance commitments.

Question 9.3 Do you consider there are aspects of company performance where it would be better not to set expectations as part of the price control? What approaches should we consider in these cases, so that companies act in the interests of customers?

(263) We agree that, in theory, this could help simplify and rationalise the outcomes regime.

(264) However, this proposal may not deliver any additional benefits in practice. The water sector operates within the broader political landscape and is responsive to the changing expectations of its customers and stakeholders. This is particularly true for purpose led-businesses. For example, the industry has led the way for the wider economy with its public interest commitments and ambition to achieve net zero carbon by 2030. The industry has also responded to the needs of its customers in light of the Covid-19 pandemic. As such an additional mechanism outside of the price review process appears superfluous, given the existing reputational incentives companies face. In our case our social contract and company purpose will ensure that we respond appropriately to emerging customer needs.

(265) We are cautious about how new and emerging needs would be agreed in practice. It is not apparent that additional requirements can be expected to always be delivered by base funding, when those requirements are not yet known. As such we would urge that alongside this proposal, if it progresses, Ofwat outlines how such requirements would be identified and agreed with the industry.

Question 9.4 What should be our aim in setting the levels of performance commitments? Do you agree with the suggestion that performance commitment levels should be set, as a starting point, at what can be achieved by an efficient company with base costs and that deviations from this are proposed in company business plans? If not what alternative proposals should we consider?

(266) A key aim of setting performance commitment levels (PCLs) is to set standards supported by customers linked to long term outcomes. We agree that companies should be funded to deliver the PCLs agreed with customers.

(267) However, we have some reservations regarding both the principle and robustness of a mechanistic approach to setting PCLs derived from base costs. This approach would remove customer views as the starting point for setting service levels, with customer views focused on a few specific areas of deviation from the base funded levels of service.

(268) Getting robust approaches to cost assessment reflective of regional differences will be a critical success factor for the upcoming review and beyond. This extends to establishing a clear understanding of the links between costs, service and risk in setting future allowances and targets. This was partially explored during the CMA redetermination process, which challenged the strength of the statistical relationships between cost efficiency and service performance used to support Ofwat's stretch in setting PR19 targets absent of a clear understanding of how this related to the costs of each individual company to achieve a given level of service[26]. The CMA also looked in detail at companies' proposed leakage costs associated with both maintaining and improving service, recognising these vary significantly dependent on the level of service, regional factors and the current technology deployed. This is demonstrated by our one-off and recurring base costs for leakage at PR19 are illustrated in the table below, but applies equally to other performance commitments.

One off expenditure		**Recurring expenditure**	
Item	**Value (£m, 2017-18)**	**Item**	**Value (£m, 2017-18)**
Base costs			
Mains replacement (capex)	15.3	Advanced noise sensors	28.6
		Advanced pressure sensors	17.4
		Intensive find and fix	12.8
Enhancement costs			
Communications network (enhancement opex)	32.4	Smart meter installation	68.6
Water efficiency opex, customer supply pipes	5.1	Operation of fixed data network	8.1
		Total	**188.3**

[26] Specifically CMA Final report para 4.221

(269) Maintaining improvements can increase costs. In certain instances where levels of performance vary between companies, the level of stretch introduced by percentage improvement targets will vary between companies. The link between performance and costs was recognised in the case of leakage by the CMA in its redetermination.[27]

(270) This doesn't mean that base costs shouldn't be the basis for which PCLs are set, but that there should be a round of engagement with customers as part of setting base costs to determine which areas they are prepared to fund service improvement. Setting an appropriate ambitions for improvement, supported by well calibrated incentives will support focus on long-term improvements in areas valued by customers or critical to the environment.

(271) The PR19 base models do not always account for regional variation in operating circumstances nor do they include service parameters. In due course we would encourage Ofwat to engage and consult further with the industry on its approach to assessing levels of service. This should explore how performance for each common performance commitment varies with parameters such as network scales, network densities, topography, number of properties etc.

(272) The relationship between cost and service warrants further exploration to avoid unintended consequences for companies and perverse incentives which detract from the longer term focus we and Ofwat agree is imperative#.

(273) During AMP7 more data will become available on the level of cost and performance delivered by the industry in response to the challenging PR19 determinations. Data from year one of AMP7 suggests the current level of stretch on cost and service for common performance commitments is considerable. Ofwat should reflect on industry performance during AMP7 when considering the level of service funded by base expenditure.

(274) Our preference is that Ofwat undertakes a blended approach grounded in economic theory, whereby the level of service improvement is set reflecting customer priorities and the cost of improving service. This would be similar to the approach adopted at PR19 but involving information from Ofwat's early view of base costs and outputs of customer valuations from the collaborative research.

(275) We support the early visibility of base cost models, PCLs and outcome delivery incentives. For this to aid Business Plan development, the PCLs must be made available by January 2023 at the latest.

Question 9.5 What approach should we take to setting ODIs? How should we take account of marginal costs and marginal benefits in setting ODI rates? What are the risks and benefits of the approaches that we set out, or any others that you propose?

Reflecting customer views

(276) We agree that setting incentive rates should be driven by the value that is unlocked for customers and the environment for changes to service. This is consistent with how we sought to use our customer engagement work in previous reviews in shaping both our investment proposals and associated outcomes incentives based on the value to customers and the environment.

(277) It should be uncontentious that companies' business plan outcome measures and incentive rates should be informed by the views and priorities of their own customers. The legitimacy of the

[27] CMA Final Redetermination, para 8.77a

regulatory regime is undermined if customers are not the visible driving force in shaping companies' future plans and priorities.

(278) We understand Ofwat's desire for greater consistency in customer research for common measures at PR24. We believe the best approach is standardisation of regional research, rather than a national study. Standardisation would remove the methodological concerns held by Ofwat at PR19 while ensuring regional customers views are used to prioritise investment programmes and reflected in company ODI rates. It would also place the industry in control of the timetable for this work and allow alignment between values used to optimise investments and set ODI rates.

(279) National research risks missing regional views and priorities. As discussed in our response to the points raised in Chapter 6, our preference is that standardised approaches are used regionally through the collaborative research, so that our customers views are reflected in our ODI rates rather than those of customers in England and Wales more broadly. Establishing clarity on the relationship between national research and regional work to avoid duplication and inefficient effort should be a priority in the coming months.

Funding service improvements

(280) There are several commitments which the sector must deliver over a long-term timescale, that should come with long-term price path commitments. These include delivering net zero, drought resilience, strategic growth and long term removal of lead from the water network. The nature of these investment drivers span well beyond five year price control periods, and is very different to recurring base costs for which the short-medium term cost assessment is more robust.

(281) We are interested in Ofwat's proposal that service improvements are funded by ODIs in period. This would work in the same way that our PCL and ODI operated for leakage in AMP6, as it funded and rewarded performance that shifts the frontier through an ODI mechanism. Ofwat could look to explicitly include marginal costs for performance within the incentive rates to directly fund potential service improvement in period. This approach could also be applied to operational resilience or asset health metrics to fund additional efficient capital maintenance within price review periods, improving the flexibility of the regime and encouraging companies to invest in the face of their long term challenges.

(282) However we believe the default should be enhancement funding to improve service with other approaches considered by exception as this provides greater investment certainty and can be coupled with Price Control Deliverables if sufficiently material.

Transforming performance

(283) Making individual company incentive payments contingent on industry performance would dampen individual company incentives to improve, given the performance of the wider sector is largely outside of management control and the costs of doing so vary hugely. Varying cost of service improvement were explored by the CMA in regard to leakage, which noted costs may be higher if operating conditions are more challenging or if performance is high.[28]

(284) We agree with Ofwat that it is too early to conclude on the efficacy of the enhanced incentive regime at PR19 but note that the existence of incentives to encourage frontier shifting performance remains,

[28] CMA redetermination, paragraph 8.136a & 8.136b.

and that enhanced incentives are a potential option for this. We believe there is a strong need for Ofwat to review how it incentivises companies who shift the frontier.

(285) We believe that greater reflection on individual outperformance caps per measure should be reviewed at PR24, as these can stifle incentives for companies to innovate to strongly outperform or shift the existing performance frontier. If an aggregate outperformance cap is retained at PR24, then the calibration of individual performance commitments becomes less load bearing.

Chapter 10: Cost Assessment

(286) We welcome Ofwat's initial comments regarding the way in which Cost Assessment will be handled at PR24, recognising there is a significant collective sector effort required to explore the themes set out in Ofwat's proposals. However, there are also a number of factors not raised in the document which need consideration as part of the PR24 design. We start our response to chapter 10 by addressing these additional factors before going on to respond to the nine questions raised by Ofwat in the document.

Key Points

(287) The PR19 approach to cost assessment will not work for the multi-AMP, opex-based programmes that will be required to meet future challenges. The costs of such programmes should be assessed in a very different way from the remainder of companies' investment programmes, for which a five year process remains appropriate (see 'The need for a change in approach to enhancement cost assessment' below).

(288) We support the publication of base models in advance of business plan submission and note that publication would need to be done by the start of 2023 to be effective. We encourage the early release of enhancement models as well. Early publication of the models must be accompanied by clarity about how Ofwat will use them to assess costs - for example, the treatment of mergers (see 'Process issues' below).

(289) We urge Ofwat to set out its approach to determining frontier shift (productivity and RPE) at PR24. There is urgent need for new analysis of quality-adjusted productivity improvements in the water sector to inform AMP8 assumptions (see 'Productivity/ Frontier shift' below).

(290) While agreeing in principle that benchmarking outside the England and Wales water sector could be useful, in practice we are sceptical that reliable benchmarks can be found for most activities. Much more could be done with the rich datasets from the England and Wales companies (see response to q10.1-10.2).

(291) The costs of achieving net zero will be substantial and not represented in historical expenditure. To inform future costs, a new reporting table for decarbonisation costs should be introduced (see response to q10.3). On costs and service more broadly, we need to develop means of understanding better the relationship between costs and service and of assessing whole-life costs where solutions are opex-based (see response to q10.4-10.6).

(292) On long-term resilience, cost assessment must include a forward-looking element if historical expenditure levels do not reflect the expenditure required to maintain ageing assets and address future risks. More and better measures of resilience are required if the maintenance of resilience is to be adequately funded (see response to q10.7-10.9).

(293) Before responding in detail to the nine questions set out in chapter 10 of *PR24 and beyond: creating tomorrow, together*, we have added in three further sets of issues which are, at least in part, referenced in the body of chapter 10 but not set out explicitly as questions. These issues deserve to be considered carefully as part of the process of setting the PR24 methodology.

The need for a change in approach to enhancement cost assessment

(294) In *PR24 and beyond* there is a very welcome focus on the long-term as part of the themes for PR24. This shift in emphasis must be followed up with a consideration of how the PR24 approach to addressing enhancement can best deliver for the long-term such that the process is commensurate with the ambition to deliver for the long-term. This is the right time to consider significant changes to the enhancement cost assessment process to ensure timely and effective investment in long-term enhancements that span multiple price controls and that this requires a different approach to that which may be suitable for assessing efficient recurring base costs over a single price control period.

(295) There are several commitments which the sector must deliver over a long-term timescale, that should come with long-term price path commitments. These include delivering net zero, drought resilience, strategic growth and long term removal of lead from the water network. The nature of these investment drivers span well beyond five year price control periods, and is very different to recurring base costs for which the short-medium term cost assessment is more robust. We therefore consider that differentiation between short-medium term base and longer term enhancement would ensure robust challenge on the efficiency of base costs while ensuring companies have the right long-term allowances to deliver the step-change which is needed to deliver long term ambitions. This could involve considering separating multi-AMP investments from the 5 year cost assessment approach, and consider the whole life costs of investments, nature based solutions and the broader social and environmental value delivered through these schemes.

(296) Taking a step back on enhancement cost assessment and considering how it could best support the delivery of long-term ambitions (including whether minor changes to the PR19 process would be fit for purpose) is vital for ensuring the translation of the proposed PR24 themes into reality. An important part of this will also be the consideration of how enhancement interacts with base cost assessment and ODIs in the round to support the delivery of stretching outcomes and delivery of long-term ambitions whilst not inadvertently creating a cost-service disconnect.

Process issues

(297) In section 4.2.1 (page 34) of *PR24 and beyond: creating tomorrow, together,* Ofwat wrote *"We will consider whether it is possible to provide companies with an early indication of potential cost models as well as greater clarity over potential cost adjustments".*

(298) Consistent with our discussions with Ofwat during PR19, we fully support the early visibility of base cost models and all supporting data. But for this to aid the development of the PR24 Business Plan and enable companies to challenge themselves more effectively, the models must be made available by the start of calendar 2023 at the latest. Any later than that, and there will not be sufficient time for the key insights which the models would provide to be incorporated into the business planning process.

(299) We recognise (and share) Ofwat's concerns that early release of the models leads companies to re-examine the data they submit for the independent variables. We were surprised and somewhat disappointed at the scale of changes in pumping station numbers that some companies made after the models were released at IAP. If these changes are valid, they should improve the quality of the models. If they are not, there are powers within the regulatory framework to sanction companies whose assurances over the reliability and accuracy of data they have provided are proved to have been wrongly given.

(300) We would urge Ofwat to provide early visibility of the enhancement approach to cost assessment as well. The same arguments which hold for base costs equally hold for enhancement. Early information on the form of base and enhancement assessment would provide valuable information in our efforts to challenge ourselves effectively. In both cases, having clarity over which factors are being taken into account in the modelling framework to assess the level of efficient costs allows companies to judge whether and where they need to submit Cost Adjustment Claims (CACs) to take account of material factors which are not accounted for in the models. Providing this visibility early, avoids wasting time and resources for both companies and Ofwat and would allow for a genuine streamlining of the process.

(301) We would urge Ofwat to also consider providing early visibility of service levels and ODI rates at the same time. Whilst this point has been made separately elsewhere in our submission, we felt it was important to repeat it here to stress the need for clarity over both sides of the ledger: what outcomes are expected to be delivered and the resources which will be available to deliver them. We understand Ofwat is prioritising analysis in support of determining the level of service supported by base costs, so this would align with the publication of base cost models.

(302) To achieve the desired purpose of providing insight into expected base and enhancement allowances and the drivers used by Ofwat to determine these, the models would benefit from being accompanied by all necessary associated information – for example:

i. How mergers are to be handled, both in terms of developing the cost models and in terms of evaluating the AMP8 forecasts. This posed problems with the Severn Trent / Dee Valley Water at PR19 and the SWB/BRL proposed merger will raise similar problems at PR24.
ii. If Ofwat could set out the approach it proposes to take to setting catch-up efficiencies, then companies can make a reasoned judgement of what the efficiency challenges are likely to be. Consequently, companies will be better able to understand potential gaps between Business Plans and expected assessments and challenge themselves accordingly.
iii. Were companies to publish their expectations for 2023/24 alongside their 2022/23 APR and their forecasts for 2024/25 alongside their 2023/24 APR, then by knowing the form of the models, companies would have clarity over what the models would predict for AMP8 at DD and FD respectively, assuming that Ofwat used the most recent data available at each stage.

(303) We would urge Ofwat to make use of the most recent data for cost assessment throughout PR24, up to and including the Final Determination. At PR19, Ofwat did so for the Final Determination in December 2019, making use of the 2018/19 data which had become available after the Draft Determination was issued in July 2019. Similarly, the CMA chose to make use of the 2019/20 data for the Final Redetermination. While the 2019/20 data had been published before the Provisional Findings, there was not time for the results to be reflected in the CMA's PF analysis.

(304) We would urge Ofwat to use either five or ten years' data for developing cost models so as to cover either one or two whole AMP cycles. We appreciate it is not feasible at the Final Determination to cover all of AMP7 cost data as 2024/25 is not available until more than six months after the FD comes out. However, working with either five or ten years' data (dropping the earliest year and replacing it with the most recent year as new data becomes available) would avoid any "exceptional year" arguments as one or two whole cycles would be represented in the data used to develop the models. Our preference would be to use just the most recent five year's data both to build the models and to evaluate them. To an extent, were Ofwat to incorporate a time trend within the model, our preference would be more equivocal. However, even if a time trend were included, issues of data consistency over longer periods (e.g. the recasting of prior cost data to take account of the move to IFRS) would still on balance leave us preferring a five year panel. Having reviewed the models for the five years

ending with each year of AMP6 (that is respectively, the five years from 2012 to 2016, from 2013 to 2017, from 2014 to 2018, from 2015 to 2019 and finally from 2016 to 2020), we consider that the up-side of the parsimonious approach to cost modelling is that stable models are generated with just five years' data. By contrast, using 10 years' data seriously weakens the incentives to achieve efficiencies and also means that allowances are partly determined by very old data.

Productivity / Frontier shift

(305) We believe it is very important for new analysis of quality adjusted productivity in the water sector to be undertaken, building on the 2017 Frontier Economics study. That report, the only recent piece of research into water sector productivity in recent years, is already four years old and hence outdated. Given the importance of the topic, there is an urgent need for analysis which commands widespread acceptance. Insofar as it is feasible, an ongoing study running over AMP7 which would allow the industry to evaluate the impact of the productivity challenge imposed by the PR19 settlement could help shape the debate over feasible values for AMP8 productivity gains to be used at PR24. We intend to initiate an industry effort to undertake this work.

(306) At PR19, Ofwat introduced a number of novel aspects to its assessment of real price effects (RPE). In particular, it set out a four-stage process for determining if a particular category of cost warranted a RPE adjustment within the cost assessment process. It would be very helpful for Ofwat to set out explicitly how it intends to handle RPEs at PR24.

(307) We would urge Ofwat to set out its approach to Frontier Shift at PR24. In particular, will Ofwat continue its PR19 approach to viewing productivity and RPE as separate topics or its prior approach of seeing the two elements holistically? As they are effectively two sides of the same coin, our strong preference is that they should be addressed together as they were at PR09 (explicitly) and PR14 (implicitly). It would also be very helpful to consider what data should be collected to avoid the possibility of double counting productivity gains when using forecast cost data for enhancement cost assessment.

Responses to Individual consultation questions

Question 10.1 What should be the priorities for improving our approach to cost modelling and assessment?

(308) We recognise that Ofwat will build on the PR19 suite of models. With this as a starting point, we make the following suggestions of potential routes towards improving the base cost models:

i. We do not favour prioritising trying to develop totex cost models. Given the nature of enhancement capex, totex models were unsuccessful with a much richer array of cost drivers at PR14. Given the predisposition towards parsimonious models at PR24, based on the PR19 approach, we see no reason to think a revived attempt to develop totex models will be any more successful this time around. Rather than hoping for a way out of the problem of dealing with enhancement by bundling those costs into base cost models, resources should be focussed on assessing enhancement costs in a better way. One possible approach would be to undertake in-depth deep dives for all major enhancement programmes for all companies
ii. So as to improve triangulation across models, we would favour the introduction of a second Treated Water Distribution model within the suite of water models.
iii. In wastewater, we consider the suite of models would benefit from the inclusion of aggregate wastewater models.

iv. As a further improvement to allow triangulation across models, if Ofwat is minded to introduce any new models to its suite, we would urge the development of separate economic models rather than two versions of the same model but with alternatives to one control variable

v. We would urge Ofwat to consider again the use of Average Pumping Head (APH) within its suite of water models. The very poor (sometimes negative) correlation between Pumping Stations and energy use is counter-intuitive and a serious concern for the validity of the number of pumping stations as a cost driver. There is wide recognition that conceptually APH is the right driver to use, so as an industry we must prioritise achieving consistent data as has been achieved in other areas.

vi. Our strong preference is that base costs should cover just base opex and Capital Maintenance. Insofar as growth is concerned, we would support a review of how growth is assessed (and note this is wider than just developer services). The PR19 approach evolved during the PR19 process with materially different ways of assessing growth costs at the previous IAP and DD stages of PR19. The result was a which whilst appearing pragmatic, may have worked for some companies but clearly did not work for those with very high growth rates. As part of a broader review of how growth should be handled at PR24, we would urge Ofwat to consider separate treatment of the off-site network reinforcement costs and assess them separately to site specific or on-site activity.

vii. A key means to improve cost models, which we strongly support, is by improving the quality of the data used. In this regard, there should be a continuing effort to improve data definitions and ensure data comparability between companies by making sure all companies abide by the definitions as set out.

viii. At PR19, Anglian Water took the view that we should align the growth projections in our Business Plan with those in our WRMP. This proved to be a minority view amongst other water companies. If it is Ofwat's decided view that companies ought not to align their business plan and WRMP, it would be very helpful for Ofwat to set out its view of expected growth for the forthcoming AMP, alongside the parameters of a true-up mechanism at the end of the AMP. Our own detailed views on growth and Developer Services and how they should be handled within the cost assessment process are set out in chapter 8 of this document.

(309) In terms of enhancement cost assessment, where, for example, the WRMP has determined the need and optioneering for a particular project, the BP should not have to demonstrate the need from first principles – pointing to the requirement in the WRMP should be adequate and the scrutiny of optioneering in that process. Within the BP, the focus can then be on demonstrating the efficiency of the project.]

(310) We welcome Ofwat's commitment to improve cost assessment for developer services. However, as recognised by the CMA in its redetermination,[29] new development and population growth drive wider costs than just those associated with development sites. Ofwat's approach to cost assessment for growth must appropriately account for all the of required activity, including network reinforcement, strategic investment and upgraded treatment works. Our response to question 8.2 in this consultation response sets out further thoughts on this and the collaborative work we and others have been undertaking through Water UK on this topic.

[29] CMA, Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations, paragraph 4.848

Question 10.2 In what areas (both historical water sector and external) can we improve the range of benchmarks we use in cost assessment?

(311) While recognising in theory the value of external benchmarks as part of the cost assessment process, our experience from participating in various benchmarking initiatives in both water and non-water sectors over the years has been uniformly disappointing. The conclusion we have reached is that there are no better benchmarks for an English and Welsh water company than the other English and Welsh companies, of which there still remain a healthy number. While we would support the use of benchmarks where reliable and valid ones can be found, our strong preference would be to focus resources on improving the quality of English and Welsh industry benchmarks rather than devoting too much energy to developing benchmarks with companies outside the water sector or water companies from other jurisdictions. Indeed, we think there is much that can still be done with the existing England and Wales dataset, especially if improvements to that dataset are achieved.

(312) We consider that Ofwat can make better use of sector data to improve the accuracy of its cost models. A case in point is the detailed information we provide to Ofwat on treatment costs at water recycling works in size band 6. Our analysis indicates that unit costs consistently decline as works get larger, including within band 6. We urge Ofwat to consider using this granular information in its cost assessment. The following table computes the cost of treatment per kg of BoD_5 for each of the Ofwat defined six wastewater Band sizes. Band 6 (shown on the right of the table) is defined by Ofwat as being any works larger than 25,000 population equivalent (p.e.). As the largest work in England and Wales is ~3.8 million p.e., Band 6 has a very wide coverage. What are referred to in the table as Band 6 mod and Bands 7, 8, 9 and 10 are created from data published in the APR (up to 2020, Tale 4O). Key points to note from this table are that:

i) the data required for this analysis are already collected

ii) the unit costs are monotonic and declining from Band 1 to Band 10

iii) the absence of large works (above Band 7) has a material impact on the perceived relative efficiency of companies.

Unit costs 2020 £/kg	Band 1	Band 2	Band 3	Band 4	Band 5	Band 6 mod	Band 7	Band 8	Band 9	Band 10	Total	Ofwat B6
p.e. in Band	<250	250-500	500-2,000	2k - 10k	10k - 25k	25k - 125k	125k-250k	250k-500k	500k - 1m	>1m		> 25k
ANH	4.40	3.04	1.65	1.07	0.75	0.55	0.49	0.42			0.70	0.50
NES	3.80	2.54	1.47	1.14	0.65	0.49	0.54	1.02	0.47		0.65	0.57
UU	8.69	4.56	2.86	1.22	0.84	0.61	0.46	0.32	0.40	0.28	0.56	0.45
SRN	10.03	3.84	2.81	1.50	1.05	0.68	0.39	0.29			0.68	0.48
SVT	6.66	3.33	2.05	1.13	0.84	0.43	0.36	0.27	0.28	0.20	0.47	0.32
SWB	4.11	3.79	2.07	1.37	1.06	0.61	0.50				0.97	0.58
TMS	8.15	4.19	2.11	1.16	0.86	0.77	0.72	0.44	0.33	0.32	0.48	0.44
WSH	4.31	3.62	1.64	1.09	0.78	0.45	0.49	0.19	0.23		0.61	0.37
WSX	7.09	3.56	2.06	1.22	1.02	0.74	0.66		0.35		0.80	0.60
YKY	5.04	2.53	1.62	0.73	0.61	0.44		0.58	0.41		0.59	0.52
Total	5.64	3.48	1.97	1.14	0.82	0.57	0.54	0.40	0.35	0.30	0.58	0.45
UQ	4.33	3.11	1.64	1.10	0.75	0.46	0.46	0.29	0.30	0.24	0.57	0.44

(313) For example, it is instructive to study the unit cost of BOD_5 treated as a way of benchmarking Water Recycling Treatment across the various Bands and across companies. Taking this approach allows a

much more granular efficiency analysis of Water Recycling Centres. From our analysis, we also note that performance appears to be relatively stable over time.

(314) Following on from the last point, we would urge Ofwat to consider the disaggregation of WRC Band 6. Given the monotonic, declining unit costs as works get bigger, doing so highlights the impact of not having very large works on the overall treatment unit cost. As such, it helps benchmark companies' Water Recycling Treatment performance more accurately.

(315) The WRc TR61 suite of capex models has 40 years' pedigree. We intend to make use of this resource during our PR24 preparations and commend it to Ofwat as worth considering from a benchmarking perspective. It provides a rich array of standardised models developed over a long time horizon. There have been six price reviews since privatisation. While there have been several approaches taken to assessing opex and capital maintenance efficiency over this time, there has not yet been one generally accepted mechanism designed to measure directly the efficiency of enhancement capex. Given the extreme difficulty that has long been recognized regarding evaluating enhancement capex efficiency, TR61 may provide a comparison tool which can help partially address this problem.

(316) Our experience shows that benchmarking of support functions, even within the sector, is very difficult. We understand the attraction of such an approach but would advise extreme caution going down that route. We believe that better returns for effort expended are likely to be available from focussing resources elsewhere.

(317) However, we do believe that customer service as an element of Retail does lend itself to benchmarking beyond the water industry. We would support efforts to follow this approach.

(318) Finally, we consider that RAPID schemes may provide benchmarking opportunities for some capital projects such as for treatment and transfer solutions within the WRMP.

Question 10.3 How can we take account of longer term ambitions such as delivering net zero and increasing public value in our approach to assessing costs?

(319) We support the approach of setting 5 year business plans within a longer-term context and discuss this further in our response to section 4 of this consultation.

(320) Companies should use their PR24 business plan to demonstrate that the 5 year plan delivering multi-AMP ambitions aligns with this longer term plan. Were this to form part of the PR24 cost assessment process, it would avoid situations where a plan is put forward at low cost, but delays a significant amount of investment to future AMPs.

Funding the delivery of net zero and public value

(321) Delivering net zero will require a step change in how companies operate their whole business. Therefore, significant new expenditure and investment in decarbonisation will be required in AMP8 to achieve net zero carbon by 2030 as companies have signed up to in the Public Interest Commitment. Being such a significant change, the vast majority of this activity and expenditure will be new and not included in companies' historical costs. Therefore, a new reporting table for decarbonisation costs should be introduced (the table could distinguish between costs to reduce operational carbon vs embedded carbon).

(322) We note that Ofwat raises that “seeking opportunities to reduce carbon may reveal opportunities for reducing cost and increasing environmental benefits via nature-based solutions”, highlighting that there will be win-win opportunities. However, these opportunities are negligible compared to the additional required investment needed to change the way whole companies operate (and, if not possible, investing in offsetting) An overly restrictive approach could risk timely investment being made to achieve this important goal. Given the significant investment required by companies to deliver net zero by 2030, we support investment being made ex ante through totex allowances.

Approach to assessing costs

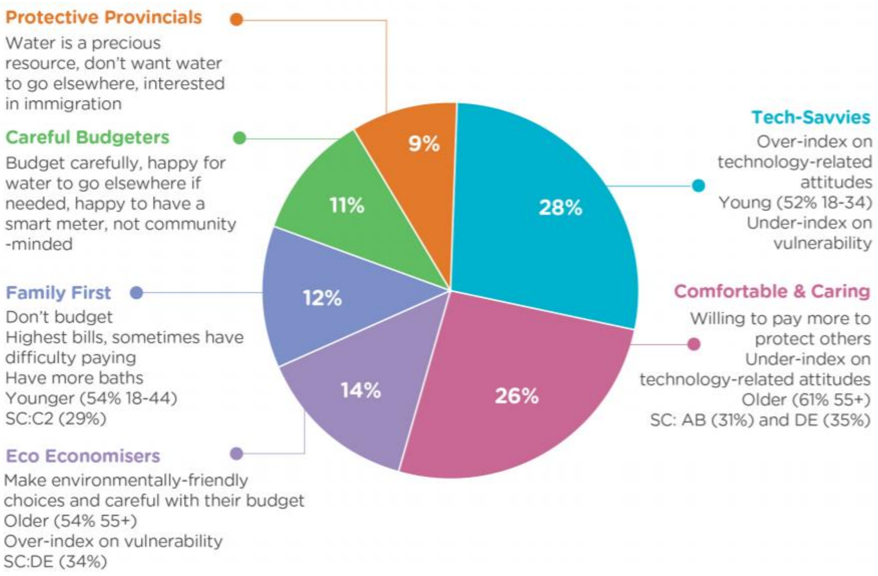
(323) Long-term ambitions and broader public value delivered by company plans could be assessed through qualitative aspects of business plan assessment, such as cost adjustment claim and enhancement assessment criteria. This could be through a specific assessment criterion allowing companies to set out the additional value added by an investment and how these have been valuated. It could also be assessed through the optioneering assessment criterion, through which companies would demonstrate how they have assessed the broader benefits of the different potential investments. Different solutions proposed by companies could show their wider benefits and how companies have taken these into account within the optioneering process.

(324) Taking into account that long-term ambitions will require a multi-AMP approach to assessing costs, a greater emphasis should be placed on whole-life cost (WLC) assessment for programmes which are identified as having options which may have costs and benefits over their whole life to that when observed over a five year period. This is particularly relevant to programmes with a long-term focus and those which have options that would provide broader environmental and social benefit (e.g. nature based solutions to WINEP obligations). Assessing costs on a whole-life basis could also offer the additional regulatory benefit of having an indication of potential costs of these long-term schemes in future AMPs. This is one area which could benefit from some cross-industry standardisation of WLC assessment, to ensure costs are compared on a like-for-like basis.

The role of customer valuation

(325) Key to taking into account public value in assessing costs will be customer views, reflecting that each company’s customers are also citizens and stakeholders in their region. By definition, an assessment of public value benefits should take public/ customer valuation into account. This requires companies to have a strong understanding of customer/ public priorities for their region.

(326) Public views on the additional value delivered by investments are diverse and complicated. One way that Anglian has reflected on the diversity of views within its region has been through customer segmentation, which has been used to dig into differences and better understand the heterogeneity of customer priorities. The chart below from our business plan shows the proportions of six customer segments in the Anglian region. If the segmentation were repeated for other companies’ regions, we would expect there to be different proportions in each segment, reflecting that views and attitudes vary both within and between companies’ regions.



(327) This highlights the importance of taking company-specific information into account when considering public value of investments, and that while there will be benefits to some standardisation of whole-life cost assessments, the diversity of customer and stakeholder views between regions must also be taken into account.

(328) Finally, while the question focusses on longer term ambitions, it should also reflect long term trends, for example in capital maintenance plans – we explore this further in our responses to q10.7-10.9 of this response.

Question 10.4 Do we need to amend our cost assessment approach to take account of nature based solutions?

(329) In short, yes. However, these nature-based solutions are just a subset of a wider class of proposals, where opex based solutions are put forward for what have heretofore been seen as capex problems. It is important not to lose sight of this broader picture.

(330) Up to PR14, enhancement opex was seen as being the additional opex incurred from the delivery of enhancement capex solutions. In the context of enhancement capex, these were relatively small sums. When the starting point for assessing the opex required in an AMP was the opex incurred in the previous AMP, the enhancement opex from the previous AMP would be added to the base opex as the enhancement projects from that period would become part of the base in the following period. With the introduction of a totex approach came a new form of enhancement opex, namely the opex incurred in solving what previously would have been seen as being a capex problem. Nature based solutions such as Sustainable Urban Drainage Systems (SUDS) are a case in point.

(331) A factor which has limited the number of opex-based capital solutions proposed at both PR14 and PR19 was the absence of a mechanism to address this new form of enhancement within the cost assessment process. An enhancement opex solution would typically have an operational life running over multiple AMPs, generating costs throughout its life. Yet the traditional cost assessment approach would only fund the solution for the AMP in which it began. How to handle the costs incurred in the rest of its life?

(332) We would like the opportunity to consider more carefully the proposal put forward recently by United Utilities at the Cost Assessment Working Group to compute the NPV of the opex based solution over its lifetime and add the value of the NPV for the period beyond the current AMP to RCV, for subsequent recovery over its lifetime. At first sight, it seems to offer a workable solution to the problem.

Question 10.5 Where can we enhance our evidence base on the relationship between costs and service?

(333) The relationship between cost and service warrants further exploration to avoid unintended consequences for companies and perverse incentives which detract from the longer term focus we and Ofwat agree is imperative.

(334) Getting robust approaches to cost assessment reflective of regional differences will be a critical success factor for the upcoming review and beyond. This extends to establishing a clear understanding of the links between costs, service and risk in setting future allowances and targets. This was partially explored during the CMA redetermination process, which challenged the strength of the statistical relationships between cost efficiency and service performance used to support Ofwat's stretch in setting PR19 targets absent of a clear understanding of how this related to the costs of each individual company to achieve a given level of service[30]. The CMA also looked in detail at companies' proposed leakage costs associated with both maintaining and improving service, recognising these vary significantly dependent on the level of service, regional factors and the current technology deployed.

(335) In order to understand the relationship between cost and service, Ofwat should develop a deeper focus on the fundamental drivers of costs. For example, on leakage, as performance improves, there is a shift in leakage activity from traditional find and fix methods to more sophisticated detection and repair approaches which have a greater unit cost. This means that companies should not be compared on straight unit cost comparison for overall leakage, as there is a clear basis for better performance coming with a greater cost. We have recently supported Ofwat in its work to understand what cost and service data on leakage it would be useful to collect for both base and enhancement expenditure. We applaud Ofwat for recognising the need for better leakage data and believe the additional granularity which will result will provide better information to enable companies to benchmark their leakage costs and allow Ofwat to undertake a cost assessment which takes into account this cost and service relationship.

Management focus and technological change assumption

(336) Basic economics means that in general better service comes with a higher cost and poorer service costs less. The consultation document highlights the assumption on page 108 that greater management focus or technological change can reduce costs, results in a lack of cost-service connection as a high performing company (increases costs) with good management focus (reduces costs) would have the same cost allowance as a poorer performing company (reduces costs) and poorer management focus (increases costs). However, following this assumption, both the poorer and higher performing companies would get the same allowance. There would be no incentive to sharpen management focus and improve performance.

[30] Specifically CMA Final report para 4.221

(337) All else being equal, companies that are not focussed, or not using the most efficient technology, would appear inefficient in the benchmarking. The purpose of the catch-up challenge is to require them to catch up with companies that are efficient. When performance is not an explicit cost driver in the model – the catch-up challenge 'catches' the inefficient companies (those with win-win opportunities on performance and costs) and 'requires' them to deliver these opportunities through the catch-up challenge. Therefore win-win opportunities, as a means to challenge the cost-outcomes link, are not relevant.

Question 10.6 What mechanisms should we consider for the efficient funding of performance levels, set in a long-term context, that vary from those an efficient company would deliver through its base allowance?

(338) The mechanisms used to reflect the efficient funding of service levels must be viewed in the round, with performance levels aligning across performance commitments and base and enhancement cost assessment.

(339) Performance commitments and ODIs are one of the best mechanisms the industry has in replicating market pressures and in ensuring improvements/ deterioration in performance are reflecting the costs that customers pay for that service. However, it is key that existing levels of performance are reflected where there is a discrepancy in performance between companies and maintaining that higher quality of service comes with a cost.

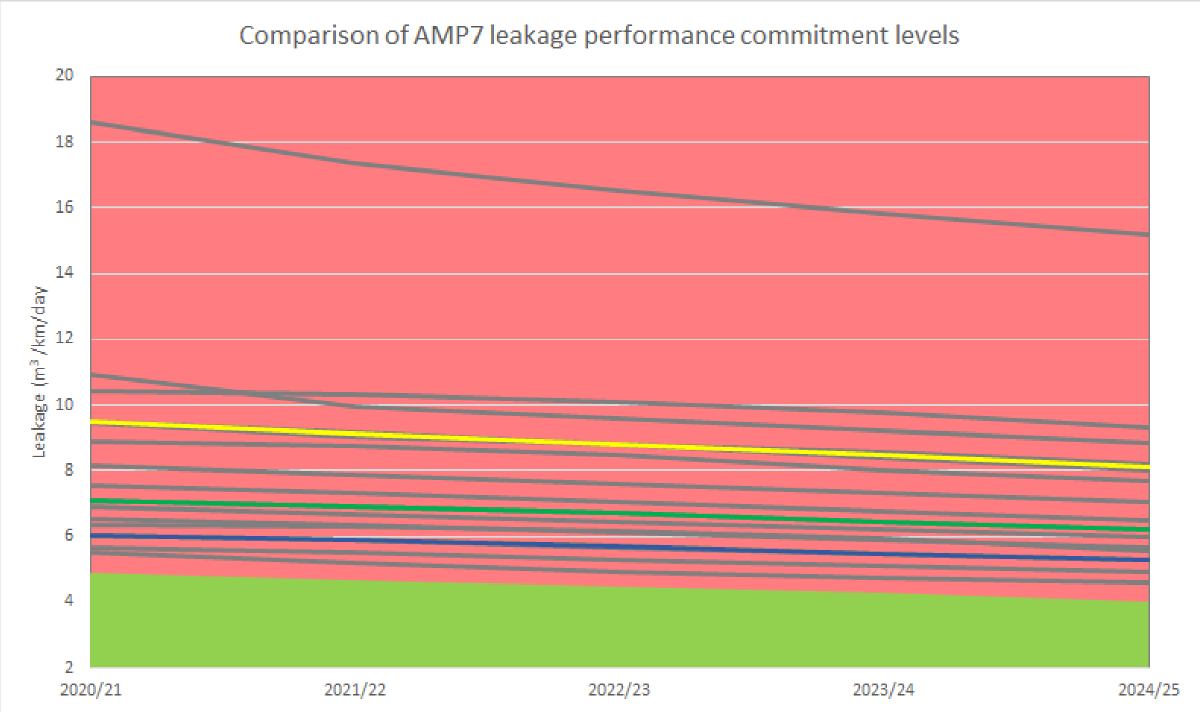
(340) Taking leakage as an example, this was recognised during PR19 as an area where Anglian's strong existing performance merited a base cost adjustment to reflect the costs of this starting point (as enhancement only reflects the costs of leakage performance improvements). An alternative approach to a cost adjustment claim on leakage would be to set a common performance commitment level for leakage (normalised for length of main and/or number of properties). This would offer the benefit of funding strong leakage performers (through ODI rewards) and applying a symmetrical negative adjustment for poorer performers (through ODI penalties). This is explored in the case study below. A similar approach could be applied to reflect the cost service relationship for other service measures.

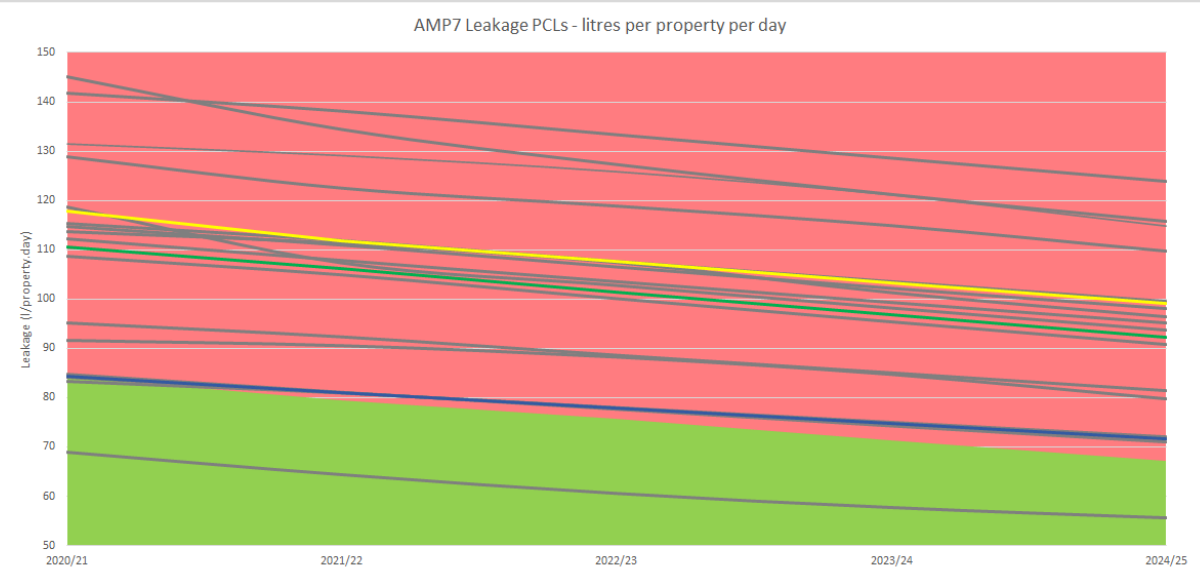
Case study: Leakage costs and performance incentives in PR19

At PR19 leakage PCLs were based on a percentage reduction from individual companies' 2019/20 performance baseline. The CMA also applied this approach in its redetermination. This provides a financial incentive to match the ambition of each company's plans to deliver a step-change in leakage reduction in AMP7.

By using companies' existing performance as a baseline from which future performance is measured, the associated incentive structure is more challenging for companies that have reduced leakage in the past and start the AMP from a stronger base. This presents a risk of discouraging companies from achieving strong performance in a single AMP for concern of creating a more challenging environment in subsequent AMPs. I.e., if the same approach were taken at PR24, could this discourage companies from reducing leakage in AMP7 through risk of being more exposed to penalties in AMP8? This would not be consistent with Ofwat and the sector aligned approach to incentivise sustained, multi-AMP improvements backed by customer support.

The charts below illustrate this position by combining data on companies' PCLs from the Final Determination with data which is now available on their 2019/20 baseline performance. They present the absolute PCLs for each company for leakage per km of main, and on a per property basis. Each company's PCL is represented by a grey line (I.e., If leakage is above this level, the company will have a penalty and if leakage is below the line, the company will earn a reward for leakage). The UQ is represented by a blue line, the average company by a green line, and the lower quartile by a yellow line. As an example, the green area shows the performance that Anglian must achieve to earn a reward, and the red area shows the performance at which Anglian would be in penalty.





These charts show that although all companies are being asked to deliver a significant reduction in leakage in AMP7, the fact that their starting points are so varied means the level of performance expected from each company varies significantly. For example, measured on a km of main basis, Anglian would be in penalty throughout the AMP if its leakage level was 5m^3/km/day. However, Thames would be in receipt of rewards throughout the AMP if its leakage level was three times this

(15m³/km/day). Similarly on a per property basis, the level of leakage that Bristol must deliver to avoid penalty or earn rewards is less than half of that required by Thames Water or Hafren Dyfrdwy throughout the AMP.

There is therefore a risk that the incentive regime set up at PR19 discourages companies from acting early and shifting the industry frontier through the risk that they will face a tougher incentive regime in a future AMP. Further to this, given the cost-service connection recognised by the CMA in its final redetermination for leakage there is a risk that the poorest performing companies, through virtue of being able to make lower cost improvements already delivered by better performing companies, can access ODI rewards for leakage more easily than those better performing companies.

Whilst some correction was made for this at PR19 through the allowance of a cost adjustment claim for Anglian, this was a one-sided adjustment where two-sided adjustments (reflecting both strong and poor performance) against leakage should be considered. This could be done by establishing a view of the leakage level delivered for the industry as a whole through base costs and applying adjustments for performance above or below this level. This could be delivered through ODIs, in which case it would need to be considered carefully alongside regional needs and customer preferences.

Question 10.7 Is there more that we need to do to reflect future pressure on operational resilience in our approach to cost assessment?

(341) We strongly agree that more needs to be done to reflect future pressure on operational resilience in the approach taken to cost assessment. We are concerned that the current structure of base cost assessment leads to insufficient Capital Maintenance allowances due to baking in low levels of historical spend over many years. Each cycle, the problem is compounded with maintenance deferred at the cost of increased risk. The problem is now made more acute as increased requirements for assets to deliver, for example, reduced leakage and moves to net zero are piled upon insufficient funding. In its May 2021 consultation document[31], Ofwat wrote "*We set the base allowance using historical costs and used forecast cost drivers to account for future changes*". We are concerned that using forecast cost drivers which themselves are based on historical trends cannot fully account for future trends where the future differs markedly from the past.

(342) With this in mind, we have supported the Water UK initiative for Harry Bush and John Earwaker of First Economics to run a pair of workshops to develop proposals which carry industry-wide support aimed at articulating how a forward-looking element of Capital Maintenance can be incorporated into the cost assessment process. The report, which is included as part of this submission, sets out the results of the workshops and strongly supports the need for a future view. The preliminary conclusion reached is that a hybrid Cost Adjustment Claim process could provide a way forward, as it leaves the existing base cost process in place, while requiring companies to justify the additional requirements, and providing Ofwat with latitude to modulate any additional assessments based upon company-specific factors.

(343) We think that The Civil Contingencies Act (2004) provides a very helpful framework for considering operational resilience. The Cabinet Office (2011) describes infrastructure resilience as "the ability of

[31] PR24 and beyond: creating tomorrow, together, section 10.4, page 106

assets and networks to anticipate, absorb, adapt to and recover from disruption". Resilience is secured through a combination of the principal components shown in Figure 1 below:

Figure 1: Infrastructure Resilience components

Source: Cabinet Office 2011

(344) The four elements are defined as follows:

- Resistance: Concerns direct physical protection, e.g. the erection of flood defences;
- Reliability: The capability of infrastructure to maintain operations under a range of conditions, e.g. electrical cabling is able to operate in extremes of heat and cold;
- Redundancy: The adaptability of an asset or network, e.g. the installation of back–up data centres; and
- Response and Recovery: An organisation's ability to respond to and recover from disruption.

(345) It appears that, so far, the debate concerning operational resilience has been framed in terms of the Resistance component within the above framework. These are the elements of operational resilience provided by enhancement capital expenditure: for example, the WRMP covers, *inter alia*, flood protection and drought mitigation measures; SEMD covers the countering of cyber and terrorism threats.

(346) The other three components of the framework are covered by base costs, either through Capital Maintenance or through operating expenditure. It is these base cost elements of operational resilience that we believe need to be taken into account in the context of base cost assessment. With this in mind, we see the incorporation of risk and a forward look to take account of new requirements into the base cost assessment process as essential.

(347) Consequently, it follows that we strongly agree with the contention that more is needed to be done to reflect future pressure on operational resilience in our approach to cost assessment. The work on forward look for Capital Maintenance forms a key part of our suggested response. However, the four-part framework set out above puts that work in a broader context.

(348) Additionally, from the perspective of Water Resources, there should be a greater understanding across the sector on how close operational systems are to constraints and thus what is the level of risk run regarding shortages in drought conditions. For example, what headroom is available and is this headroom being managed; cost assessments should consider the costs and benefits of reducing, maintaining or increasing target headroom at the asset and system levels.

Question 10.8 Are the most significant challenges to the operational resilience of the sector adequately captured within current strategic planning frameworks?

(349) The Resistance component of the Figure 1 framework set out in our response to question 10.7 is largely covered for Water by the WRMP. Security aspects of Resistance for both water and

wastewater are also adequately covered by SEMD. This is because, as Enhancement capex, these cost elements are all dealt with by a combination of models and deep dives to assess requirements and efficiency.

(350) The problems occur within the other three elements of the Figure 1 framework which are funded by base costs. These, including the future deterioration of assets, are not covered by the strategic planning frameworks. This is one key factor which drives us to the conclusion that more needs to be done to incorporate both an assessment of risk and a forward view of new requirements.

(351) Furthermore, as a result of growth being deemed within base from PR19 Draft Determination onwards in the PR19 / CMA redetermination process, network reinforcement was moved from enhancement to Botex Plus. The large, lumpy costs incurred in water network reinforcement posed a particular problem for Anglian Water at PR19 both as a consequence of high levels of growth and due to our demographics: with low population density across large parts of our region, many existing water mains are incapable of accommodating the incremental capacity requirements necessitated by large developments within our area.

(352) The fact that wastewater network reinforcement in included in Botex Plus also poses particular problems for the DWMP. A major element of the DWMP is thus delivered through econometric models which have no cost driver to allow for Water Recycling Centre growth.

(353) These are key factors which lead us to the conclusion that base costs should not include network reinforcement costs.

(354) Specifically with regard to climate change, planning for mitigation is hampered by both the absence of a) agreed scenarios for the impacts of warming by 2ºC and 4ºC and b) systems thinking which would provide an agreed framework for planning, linking, - amongst others - economic and environmental regulators, central and local government.

Question 10.9 How can we strengthen incentives for long-term operational resilience and improve the assessment of resilience enhancement expenditure while continuing to protect customers' interests?

(355) The phrasing of this question indicates that resilience is being viewed very much through the lens of resilience in the Figure 1 framework set out in our response to question 10.7; that is to say, in terms of the enhancement capital expenditure programme. Our first suggestion as to how incentives for long-term resilience can be strengthened focus around broadening the consideration of operational resilience to take account of the other three elements of the framework which are delivered through base costs and via Capital Maintenance in particular. Having a robust way to highlight where companies are sweating their assets to the extent that the risk profile is increased significantly AMP on AMP would be a good start.

(356) In order to improve the monitoring of operational resilience, it is necessary to improve the quality of the metrics used to measure operational resilience. A useful attempt was made in AMP6 with the two standardised ODIs for risk of storm flooding and risk of drought induced supply interruptions, though it is widely recognised that these measures are neither perfect nor sufficient.

(357) We would support an industry-wide effort to review the effectiveness of these metrics and attempt to develop either additional or replacement measures to better capture aspects of operational resilience.

This we propose in a spirit of humility. We recognize that the industry has been here before and that the various attempts to develop measures of serviceability and asset health since the 1999 Environmental Audit Committee report have been fraught with difficulties. The problem remains not because of intellectual neglect but because it is, if not intractable, certainly complicated and multi-faceted.

(358) We support the idea of strengthening incentives for long-term operational resilience. We believe that such strengthening would be made possible by improving the measurement of operational resilience, as discussed above. In this regard, there is also a need to consider multi-sector resilience: for example, how operational resilience in one sector affects that in other sectors, and the benefits this provides.

(359) We do not support the suggestion that outperformance payments should be deferred to the following AMP. This seems to be moving in the opposite direction to the direction of travel over the last two Price Reviews. In AMP6, the norm was for end-of-period penalties and rewards. In AMP7, this moved to a greater use of in-period penalties and rewards to help sharpen the focus on on-going performance improvement. We support this approach and are trying as hard as possible to respond to the incentive to perform: moving to deferred payments would in our opinion blunt rather than sharpen the incentive. An alternative approach could be multi-AMP incentive schemes to encourage sustainable actions and investment in measures that provide future benefits. This might include ‘traditional’ engineering schemes as well as nature-based solutions, both of which may have long development periods and delayed or prolonged benefits.

Chapter 11: Risk and Return

Key Points

(360) The CMA's recent water redeterminations at PR19 set out core principles and methodologies which represent a natural starting point for the PR24 process. We believe there should be a high hurdle for departing from the CMA's decisions and approach, given the amount of time and quality of expertise devoted to reaching those conclusions.

(361) Financeability represents a key cross check on the calibration of the price control. Where financeability constraints are identified it is unlikely that adopting changes to the specification of the notional company such as the level of gearing will replicate competitive market outcomes.

(362) Financeability conclusions should not be contingent on any assumed changes to the notional company – and in this light it will be critical to test financeability before assuming any changes to the capital structure or cashflow profile of the notional firm.

(363) The CMA's PR19 determination forms a good starting point for estimation of allowed returns at PR24.

(364) Whilst we see that cost of equity indexation has some benefits, it could introduce additional complexity, bill volatility and further complicate the testing of financeability.

(365) Accelerating the transition to CPIH beyond the 'natural' rate could lead to bill increases with no clear customer benefit. Any consideration needs to be assessed in the context of wider challenges and need for long term investments and associated pressures on customer bills.

(366) There is a suggestion that all legacy models could be included in Ofwat's financial model for PR24. We agree with the direction of travel however are conscious that such changes can be difficult to implement and could create additional complexity. Industry has significant modelling knowhow and Ofwat could consider a modelling group to consider and resolve these.

Responses to Individual consultation questions

Question 11.1 Are there areas of our risk allocation framework where mechanisms could be added, simplified or removed in a way which would benefit customers?

(367) We welcome the proposal to reduce complexity and improve understanding of risk at PR24; and agree that some mechanisms adopted introduce unnecessary complexity that is disproportionate to their impact.[32]

(368) The framework should have clear hurdle rates or tests for inclusion or removal of mechanisms within the risk allocation framework which could for example include:
- materiality;
- cost benefit analysis; and
- financeability implications.

[32] CEPA (2021), Allocation of Risk: Prepared for Ofwat, June 2021, pp.10

(369) Although we are still in the process of learning what has and hasn't worked at PR19[33], it is vital that Ofwat consider asymmetry as part of risk allocation and whether asymmetric downside risk implied by regulatory mechanisms is in the customer interest at PR24.

Question 11.2 How should we improve our use of RoRE risk ranges to provide insights into the balance of risk and reward, and improve comparability across companies?

(370) We welcome and support the initiative from Ofwat to seek improvements to the insights into risk exposure and the balance of risk and reward that can be obtained from RoRE risk ranges. We would support a robust risk analysis undertaken at PR24 that underpins the design of regulatory mechanisms and allowances and provides real insight into companies' risk exposure[2] and plans.

(371) We recognise that companies adopted different approaches to the RoRE analysis at PR19 and there may be merit in improving comparability across companies. In particular there is scope to develop, for certain costs and incentives, common data and approaches to stochastic modelling which could improve understanding of risk.

(372) Risk assessment for a water company is complex and will likely require multiple approaches to ensure robust understanding of the likelihood and scale of risks, changes in risk exposure over time interconnectivity of risks, and the velocity of risks (i.e. when might a risk crystallise). We expand on potential complexities below:

- Structural breaks in risk can be difficult to capture as stochastic risk models typically rely on historical data and for some risks the past is not a good guide to the future.
- The interconnectivity of risks i.e. the link between risk and the scope of one risk to magnify another and for risk in combination to be greater than the individual risk is also difficult to model. This issue is also highlighted by CEPA in its recent paper.
- Risks which are not normally distributed and 'black swan' events are difficult to capture through risk modelling.

(373) These factors *inter alia* will need to be carefully considered when developing methodologies for risk quantification.

(374) Anglian considers that a complete understanding of the risks across the sector requires both sector-wide and company-specific risk analysis. As risk drivers and the interaction between different risks can be complex and vary between companies, there are limits to the insights which can be provided by sector-wide modelling. As a result, comparability should only be improved to the extent that it does not hinder stakeholders from obtaining a complete understanding of company-specific risk.

(375) Overall, we welcome efforts to improve comparability in areas with common parameters such as setting out common methodologies for risk measurement. A greater emphasis on risk analysis may improve techniques for risk quantification, improve the evidence base available to support regulatory decision making and help stakeholders of the industry, including customers, to better understand risks and opportunities in the industry.

[33] Most of the reconciliation mechanism are for PR19 and it is only 1.5 years in the AMP

Question 11.3 Should we index the allowed return on equity, and if so, how ought this to be implemented?

(376) We are open to changes that make regulation simpler. The idea of equity indexation is indeed interesting, however, there are new risks which could be introduced by this mechanism which will need to be carefully evaluated. This will also add another layer of complexity.

(377) A key aspect of water regulation is financeability testing. Companies rely heavily on debt markets and as the CMA concluded, there is a direct link between the cost of equity and financeability. One issue with introducing indexation to the cost of equity is that the financeability test will become even more complex to carry out.

(378) In relation to the potential means of implementation, we consider that indexing the Risk Free Rate (RFR) only – consistent with Ofgem's approach for RIIO2 – appears to be a reasonable starting point. However, we remain cautious about the benefit this will bring to water customers, in particular given the expected complexity and fluctuation of customer bills.

CAPM and cross-checks

(379) We consider that CAPM evidence should be the primary evidence for setting the allowed returns with limited weight placed on cross checks. The question of CAPM has been asked at times in regulatory cycles however it remains the most established methodology that is acknowledged to be the most robust and universally accepted bottom-up model for asset pricing and estimating returns by finance practitioners, used by regulators around the world and that is best understood by the stakeholders including the investor community.

(380) Alternative asset pricing models could represent relevant evidence to cross check the CoE derived from CAPM but not all possible 'cross checks' are necessarily robust or improve precision of the cost of equity estimates based on CAPM.

(381) There is also a real risk that unreliable cross checks could lead to biased and wrong estimates so we would welcome early engagement with Ofwat on the design and specification of any cross checks before they are reflected in PR24 methodology.

Question 11.4 To what extent should we place weight on a) balance sheet data; and b) index data when setting the allowed return on debt?

(382) The approach to setting the allowance for the cost of embedded debt was considered in great detail over the course of the PR19 Redetermination and there should be a high hurdle for departure from the approach and fundamental principles adopted by the CMA. These include for example:

- The importance of careful analysis of debt costs across the sector to inform the allowance;
- That all economic costs need to be taken into account, including costs associated with derivatives;
- The need for appropriately calibrated notional cross checks which reflect the long-term nature of financing in the sector (i.e. by adopting 20Y trailing average based on market benchmarks) and

are based on parameters clearly specified ex ante (such as the proportion of floating rate debt); and

- There is no requirement for an adjustment for the halo or outperformance wedge on cost of debt.

(383) The ex-ante predictability of Ofwat's approach to setting the cost of debt (CoD) is critical for minimising asset liability mismatches (where the asset is the allowed CoD) and therefore retaining and attracting low cost finance. Adherence to the CMA's principles and methodology in this context would support the stability and predictability of the regulatory framework and incentives.

(384) There are a number of challenges that will need to be taken into account in setting a cost of debt for the sector – in particular the wide range of observed debt costs means that calculating an average that is a reasonable proxy for efficient costs is problematic. This large range in outturn CoD cannot solely be explained by superior/(inferior) efficiency (i.e. firms being able to issue debt below/(above) a market benchmark on a like for like basis) but instead by, *inter alia*, timing differences and firms taking more or less interest rate risk. Given where we are in the economic cycle, firms that i) took on more interest rate risk and ii) issued debt more recently have got a comparatively low CoD.

(385) In our view a demerit of an approach based on the sector average is that there is a risk that – where companies take on more risk over time and this is reflected in policy – this increases risks assumed for the notional company (and hence customers). As well as this, the financing structure that is implicit in the industry-wide allowance is more difficult to predict ex ante. Absent visibility of the debt strategies of the firms in the industry, it is difficult to develop a debt strategy that minimises asset-liability mismatches.

(386) As a result, we consider that more weight should be attached over time to the costs implied by index data than the sector average. Specifically, we consider that there is merit in developing ex ante a view on what constitutes appropriate notional financing for PR24 including (1) debt composition (2) tenor of debt (3) timing of issuance. The notional financing used by the CMA for its cross checks is a useful starting point and – if used to signal ex ante how embedded debt allowances will be set – provides clear incentives and risk allocation.

(387) There is also in our view significant work to be done to formulate a clear and transparent policy for the estimation of the sector's debt costs building on the CMA's approach, which will need to consider how to estimate robustly the sector average costs (for example how to incorporate certain types of financial instruments).

(388) The industry average is likely to be sensitive to these adjustments and we welcome the opportunity for detailed and constructive engagement with Ofwat to support clear and robust application of a policy based on sector average costs, provide companies and stakeholders with requisite level of clarity around the policy.

Single cost of debt allowance

(389) Setting a single allowance for cost of debt may appear simple *prima facie*, however, there are important implications from such an approach that must be factored into the decision. For example, setting a single allowance implies full indexation of the cost of debt which could result in a material change in risk allocation relative to PR19 and could introduce mismatches between company specific costs, sector average costs and the allowance under different macroeconomic

scenarios. Furthermore, full indexation could impact on systematic risk exposure which could have implications for beta estimation.

(390) Whilst we see the case for simplicity, we remain cautious whether this is suitable for the water industry at this stage.

Question 11.5 Should we allow adjustments to the sector allowed return based on company size - and how should this be assessed?

(391) This should be supported by the principle that the allowed return should remunerate a company for its required costs. If there is clear evidence that a company has higher costs due to its size, we would support that allowed return should reflect those costs.

Question 11.6 Should we make different assumptions for the PR24 notional structure compared to PR19, and how should such a change be implemented?

(392) Financeability as a cross check is an established and necessary analysis as part of the regulatory review. Financeability tests represent a robust cross check on calibration of allowed returns and can be used to identify whether core regulatory judgments require re-calibration.

(393) Decisions about notional structure are important in this context as to whether notional financeability tests are meaningful depends on robust specification of the notional company. Typically, we have understood the notional company to be broadly equivalent to the sector average company, which reflects market evidence from companies and is a proxy for a competitive market outcome. This is for example reflected in the CMA's approach to embedded debt based on sector average costs, or the evolution of notional gearing which at least initially closely followed observed gearing across the sector.

(394) Where the notional company departs from market evidence, there is a real risk that financeability tests cease to be meaningful. It is also important that the notional company is stable and predictable over time to support investor confidence that notional financeability tests are robust and reflect real world dynamics. As a result, there should a high hurdle for any departure from the notional structure and assumptions set out in the CMA's PR19 determination.

(395) To put it another way, a reasonable notional structure needs to be specified *ex ante*, on its own merits. This structure would then serve as an input into the financeability analysis to test the adequacy of allowed returns and other regulatory parameters. Changing the notional structure to address financeability constraints would reverse this logical sequencing and undermine the financeability test.

(396) The CMA considered a number of potential solutions to address financeability constraints at PR19 including use of fast money levers (as implemented by Ofwat in its determination), accelerated CPIH transition, changes in notional gearing and change to the proportion of index linked debt held by the sector.[3] The CMA did not consider that these approaches were appropriate solutions to address financeability for the notional company and did not rely on these changes in its financeability assessment.

(397) Even where changes to the notional structure are warranted, they should be applied in such a manner that does not render financeability conclusions contingent on any assumed changes to the notional company. This means that in such cases financeability should be tested assuming no changes to the capital structure or cashflow profile of the notional firm.

(398) We comment separately on the scope for any changes to gearing and the proportion of index-linked debt. Given the decisions made by the CMA and commentary below, we do not see a case for a change of the notional company.

Gearing

(399) The gearing of the notional company is already low when compared to the observed average gearing of the industry and as a result the market evidence does not support further reductions, which would increase the variance between the notional company and the sector as a whole.

(400) A reduction in gearing does not replicate a competitive market outcome for the notional company. Where financial headroom implied by a given level of returns is not adequate to support financial resilience/headroom or management of risks, the efficient market outcome would be a higher required return on capital to reflect business risks.

(401) We also note that changes in gearing are costly (equity issuance costs are typically estimated at c.5% of equity issued), and there are also implications for the ratio of new: embedded debt.

Index-linked debt

(402) We continue to believe that 33% represents an appropriate level given the composition of debt in the industry and the ongoing transition to CPIH. We see no evidence which supports a departure from the levels assumed by the CMA at PR19, and changes could undermine the predictability and stability of the notional financial structure assumed across successive price reviews.

(403) Moreover, as existing index-linked debt in the sector is primarily RPI-linked and the CPI-linked debt mark is at a nascent stage, companies are using the swap market to raise CPI-linked debt. It will be important to consider (1) whether to assume RPI- or CPI-linked debt for the notional company (2) the condition of IL markets and sustainability of the index linked percentage assumed over time.

(404) Changes in the proportion of index-linked debt to address financeability constraints would also be inconsistent with CMA decisional practice in the water PR19 referrals, where the CMA did not increase the proportion to address financeability constraints it identified for the notional water company.

“Risky” financing strategies

(405) Whilst there has been a great deal of discussion about ‘risky’ corporate structures related to high gearing, there has been little by way of conclusive evidence on the same, including over the course of the PR19 Redetermination. We continue to believe that market mechanisms and tests, such as the credit rating agencies, and regulatory mechanisms work well to address risk in the sector. The CMA also undertook a comprehensive review of whether the risks or consequences of highly geared companies experiencing financial failure are likely to be large and whether there was a

regulatory gap. We agree with the CMA's conclusions that additional mechanisms over and above those that are already available to Ofwat are not warranted.

(406) Moreover, we consider that there are other potential drivers of risk that could impact on financial resilience which are relevant but have not been considered due to the sole focus on gearing, for example, risk exposures implied by financing strategies which adopt a greater proportion of variable rate or short-term debt.

Question 11.7 Do you have any suggestions for mechanisms which could incentivise financial resilience within the price control process?

(407) We recognise that Ofwat, like any regulator, holds legitimate concerns about the financial resilience of the companies it regulates and that it is appropriate to consider the potential risks and consequences, for customers and taxpayers, of a default event before it occurs.

(408) However, Ofwat already has measures in place to sufficiently safeguard resilience and protect customers. For instance, regulatory protections such as the regulatory ringfence[4] in addition to special administration[5] under licence conditions mitigate financial risks. Furthermore, there are already mechanisms and incentives in place that enhance financial resilience such as:

a. The existing regulatory requirement to maintain an investment credit rating; and

b. Covenanted companies that have de-risking features such as additional ring-fencing measures, enhanced rights for secured creditors, automatic ring-fencing measures, enhanced rights for secured creditors, automatic standstill periods and contractual dividend restrictions.

(409) There is no evidence that implies a lack of financial resilience in the sector. Suggestions for additional mechanisms need to address whether the causes of any risks (and gearing is only one component of water company financing and risk which could impact on resilience) have been correctly diagnosed and whether possible solutions would be effective and proportionate.

(410) More so, there was a significant debate in this area at the recent CMA Redetermination and arguments from both sides were considered in some level of detail. CMA carefully considered those arguments and concluded that it was not presented with evidence that existing regulatory mechanisms are insufficient to deal with the risks of high gearing that Ofwat highlighted. We do not believe that anything has changed since the Redetermination to move away from the conclusions that CMA has drawn.

Question 11.8 To what extent should we further increase the share of the notional company RCV which is indexed to CPIH in our assumptions for the period 2025-30, and how should this be implemented?

(411) We have not yet considered in detail different pathways for the transition to CPIH and are developing modelling of potential implications for customer bills, asset liability matching and risk management, and financeability. Any consideration needs to be assessed in the context of wider challenges and need for long term investments and associated pressures on customer bills.

(412) Our preference at this stage would be for a natural progression as opposed to a full transition to CPIH at PR24. The full change to CPIH exposes companies to the risk of a mismatch in revenues and debt costs – companies still carry a significant amount of debt that links to RPI. In order to hedge this risk, companies would need to enter into swap agreements to match the RPI debt payments to the CPIH linked revenue stream (as the CPI market is nascent and relatively illiquid). This implies additional cost for companies that can be avoided. We note the planned RPI reform in 2030 and therefore we do not see a case for a change at PR24.

Chapter 12: Next steps

Key Points

(413) We welcome the suggestion by Ofwat that it is considering publishing its early views of several key areas of its methodology ahead of business plan submissions. It is important that Ofwat work with the industry to agree the scope of this information and when it is to be shared to ensure that companies can take them into account when development their plans.

(414) In addition, the centralised customer research, and the outputs from that need to be provided far in advance of business plan submission (and in advance of early submissions if required by Ofwat) for companies to be able to take them into account in developing their plans.

(415) Companies will be reliant on the timely and complete provision of guidance from Ofwat, therefore we would request that Ofwat provides progress updates on a regular (at least quarterly) basis. As noted in our response, we request that Ofwat's provide the early information by January 2023 at the latest

Responses to Individual consultation questions

Question 12.1 What are your views on the draft timetable for PR24?

(416) We are pleased that Ofwat is considering publishing it's view on WaCC, base costs, PCLs and ODIs ahead of business plan submission but would wish this to be confirmed with the scope of the information and date of when it will be provided. For our full response on this, please see our response to question 4.5.

(417) We welcome the recognition that the price review process needs to align with other strategic planning framework timetables, in particular the WRMP, DWMP and RAPID. The WRMP will not be finalised until September 2023, however we would hope that costs will be sufficiently certain by Spring 2023 so that we can finalise our business plan and carry out the financing modelling, assurance and Board sign off before submission in October 2023. We could not accommodate the business plan submission date being brought forward due to the timeline of the other frameworks.

(418) We note Ofwat's suggestion that there could be an early submission with respect to enhancement schemes and are supportive of this provided the submission is seen as an early view of these schemes with likely further refinement on the scope and nature of schemes (e.g. the submission could be a description of likely schemes, but not go into the costs of the schemes until business plan submission).

(419) As noted in our response to chapter 5, we support retaining the IAP and DD as separate stages. We would request Ofwat to consider the time periods which companies have to respond to the IAP and DD to ensure there is enough time to allow for discussions between companies and Ofwat and for companies to make amendments to their Plans to reflect Ofwat's assessments.