NWG
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2019 PRICE REVIEW DRAFT METHODOLOGY

Our consultation response

30 August 2017

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2019 PRICE REVIEW DRAFT METHODOLOGY
NORTHUMBRIAN WATER GROUP'S RESPONSE

Overview of our response

Introduction

This document represents Northumbrian Water Group's response to the proposals set out in Ofwat's draft PR19 methodology consultation (July 2017). We have shared this response with our independent Customer Challenge Groups, the Water Forums, ahead of its submission.

Our answers to the specific consultation questions are set out over the following pages. Our overall message is that while there is much we support in terms of the price review framework and its main themes, we have considerable concerns in a number of key areas relating to the balance of returns, risk and rewards in the overall package of proposals.

Before moving on to discuss the draft methodology we would note that the PR19 process itself has been clear and the messaging around the price review themes has been consistent. The draft methodology contains a welcome level of detail concerning both the overall approach to the review and the methodology that will be used to set price controls.

We welcome too the fact that preparations are well advanced, the enabling licence modifications are in place and there are only a few areas of detail yet to be finalised (such as the evolving approach to cost assessment models). We trust that Ofwat will continue to engage with companies as this detail evolves.

Overall framework and key themes

As a company we support:

- the overall framework, including the structure, scope and form of the price controls;
- the high-level proposals on the mechanics of setting price controls (we have indicated our preferred options where there are choices); and
- the overall objective to create a more highly incentivised framework, with greater differentiation in returns between companies that perform well and those that perform poorly. Our response to the outcomes consultation earlier this year set out our belief that ambitious companies should be able to earn higher returns for delivering higher relative performance.

We also support the four price review themes, which match very closely the priorities of our customers. We therefore welcome the emphasis on affordability of customer bills for all and support for those in vulnerable circumstances. The theme of greater customer participation in shaping companies' plans reflects our own approach; this is the way that we work as a company, and we will continue to build on this through new and innovative approaches.

Finally we support the focus on innovation, which is a key aspect of our company culture (as evidenced recently, for example, by our highly-acclaimed Innovation Festival), and on resilience for the long term and in the round, which we know is important to our customers and to the environment.

The balance of the package

While we agree with the proposals in many areas of the methodology we have serious concerns about the package of proposals and what they mean overall. Our concerns relate not to the structure or mechanics of the price control process but to the indications given regarding the initial assessment of key parameters affecting the balance of returns, risk and rewards.

As the consultation document does not ask specific questions in this area, we have taken the opportunity to set out our views here. Were there a question on the overall balance of the package of proposals our answer would have to be that we **strongly disagree**.

One of our primary concerns relates to the very low range that is being proposed for the cost of equity, which we consider to be unduly harsh. We outline our key concerns in our response and would draw particular attention to this aspect. Our concerns relate in part to the reliance in the draft methodology on analysis that we do not consider to be robust (Appendix B of the PwC report). We have commissioned a report from KPMG, which considers the cost of equity in greater detail. The report will be published in early September.

In addition to the sharp reduction in the allowed return on equity that is being proposed, the sector also faces:

- a reduction in the allowance for financing costs, at a time when interest rates are forecast to increase – therefore risking a gap between what is allowed for and the actual costs;
- higher levels of risk through the introduction of greater market exposure in the form of separate water resource and bioresource controls;
- the higher risk associated with a move to a new measure of inflation, with a limited track record; and
- a further element of risk as a result of greater performance related revenue.

In relation to the last point, while we very much support the principle of performance related revenue, we have concerns about the balance of rewards and penalties and doubts about whether the target return on equity range is achievable in reality.

In our view the combination of these proposals simply shifts the dial too far, introducing an associated level of overall risk that threatens to undermine confidence in the sector and will ultimately impact on the outcomes the sector is able to deliver to customers.

We recognise that this review offers the prospect of a reduction in customer bills, driven by lower returns and the sharing of past outperformance. We believe, however, that a sharp reduction in bills that is caused by an unduly harsh reduction in returns would ultimately act against customers' interests by undermining investor confidence – risking a sharp increase in prices at the end of the PR19 control. This would be similar to the situation that arose following the PR99 review where a sharp reduction in prices was followed by financial distress in the sector and a significant increase in prices at the next review in 2004. Such a rollercoaster ride for prices is not in the interests of customers nor does it facilitate confidence and efficient financing of the sector.

While we support the principle of performance related revenue the specific proposals in the draft methodology are heavily skewed towards penalties. We find it surprising that Ofwat's expectation is that more companies will face performance penalties than rewards and in particular that average performance should attract a penalty. This implies that an average company will earn less than the cost of capital, which would represent a significant change in risk profile for individual companies and for the sector as a whole.

Similarly although we support the principles underpinning the initial assessment of business plans, the incentives proposed are structured more to penalise poor business plans than to reward exceptional plans. We are concerned that the low financial reward available for an exceptional plan may deter many companies from this ambition and cause them to settle for a standard determination (there appears to be little incentive to seek a fast track as opposed to a slow track). Our response therefore advocates a larger reward for exceptional status and also the introduction of a financial incentive to seek fast as opposed to slow track status. We believe this will benefit customers by creating stronger incentives for ambitious business plans across the sector.

To summarise, although we support the efforts undertaken to establish a robust methodology we are concerned about the key parameters relating to returns, risk and rewards. In our view the package that is

being proposed is unbalanced and fails to incentivise the exceptional performance that Ofwat, our customers, and we as a leading company wish to see.

This is particularly concerning at a time when the UK economy is facing unprecedented uncertainty given a volatile global outlook compounded by the prospect of Brexit. Infrastructure investment is a global market and we do not believe that positive investor sentiment towards UK regulated companies should be taken for granted. Nor should we ignore the evidence that we already have of concern within the investor community, including the relatively high turnover of investors in the water sector and concerns voiced by the credit rating agencies.

2019 PRICE REVIEW DRAFT METHODOLOGY
NORTHUMBRIAN WATER GROUP'S RESPONSE

Please note that this PDF contains exactly the same content as was contained in the consultation response proforma that we completed and submitted to Ofwat. In order to be consistent with the proforma we have also included our assessment, under each question; 'strongly agree, agree, neither agree nor disagree, disagree and strongly disagree'.

Addressing Affordability and Vulnerability

Q1: Do you agree with our proposal to use the five principles of customer engagement; customer support; effectiveness; efficiency and accessibility to assess how a company is addressing affordability in their business plan?

Agree

We agree that the five principles identified in the draft methodology capture the elements a company should be using in its approach to affordability. We also support the proposal to use these principles to assess a company's approach.

Q2: Do you agree with our proposal to use information and measures, including possible common measures, to assess how a company performs against the five principles in addressing affordability in their business plan?

Agree

We agree with the proposal to use information and measures to assess how a company performs against the five principles.

Our preferred option is Option 3, which uses metrics for the principles-based approach to assess how companies are addressing affordability. This option will provide greater transparency and enable comparisons to be made. We do have concerns regarding the metrics that are being proposed, so would add this as a proviso. It would be helpful if the sector could work with Ofwat, CCWater and other stakeholders to consider this area further.

It is important that the metrics that are chosen are robust and incentivise the right behaviours. For example, a measure of efficiency such as debt management costs as a percentage of the average bill could be manipulated by reducing debt management activity (which would be against customers' interests).

Similarly, in making comparisons it is important that appropriate allowance is made for any valid differences between companies and for data quality. As an example one of the proposed metrics relates to the number of customers who receive financial assistance. Under this measure a company with a larger number of affluent customers may score poorly unless allowance is taken of this fact.

Q3: Do you agree with our proposed option for requiring companies to propose bespoke performance commitments for addressing vulnerability in their business plan?

Agree

We agree with the proposed option, which should help to promote innovation in the sector as companies are more likely to develop different approaches in this area.

We agree that at present there is not enough data that is sufficiently robust to facilitate the setting of common performance commitments in this area. There is also significant ongoing change in wider public policy (for example in relation to Universal Credit, 'Bedroom Tax', Disability Living Allowance etc), which may affect eligibility and the need for such support schemes. It is therefore likely that better candidates for common metrics will emerge over time.

Q4: Do you agree with our proposed option for using measures in our assessment of companies' approaches to addressing vulnerability in their business plan?

Agree

We agree with the proposed option; asking companies to report against a range of common measures will add context, develop understanding and potentially improve approaches. It will also form the basis from which to develop future common performance commitments.

Even without setting performance commitments, the requirement to share this information publicly will encourage companies to consider the reputational impact of the data and take steps to improve performance where necessary.

It is important that the measures selected are appropriate and drive appropriate company behavior. For example monitoring "the proportion of eligible customers receiving support" could result in companies simply tightening their eligibility criteria, resulting in fewer customers receiving support. Similarly, monitoring "the number of customers contacted by the company about eligibility for assistance" could result in poorly targeted communications.

We support the development of appropriate common measures, which might include:

1. Tracking customer satisfaction (C-MeX) for customers in vulnerable and non-vulnerable circumstances.
2. Tracking complaints from customers on our priority services register and those eligible for social tariffs.

CCWater also tracks a number of measures in relation to vulnerability, and may be able to offer further suggestions.

We welcome the proposal to look at how well companies engage with other utilities and third party organisations as part of the assessment of a company's approach. We agree that these relationships are key to supporting customer awareness of, and access to, services as well as helping companies to develop the range of support they offer. We have certainly found it beneficial to work closely with StepChange and with a number of energy companies, for example, in providing joint support to customers in vulnerable circumstances.

Delivering outcomes for customers

Q1: Do you agree with our proposals for common and bespoke performance commitments?

Agree

We support the proposed approach of using a mixture of common and bespoke performance commitments (Option 4). We also agree that performance commitments should not be aggregated as this reduces transparency to customers.

Q1a: Do you agree with the common PCs (1 – 14)?

Neither agree nor disagree – N/A

We are in broad agreement with the proposed common PCs.

However, we would also welcome the addition of sewage treatment works discharge compliance as a common PC (it is currently on the list of optional asset health measures). Performance in this area has the capacity to impact on rivers and bathing water quality, so is important to customers and is already reported to the Environment Agency. The introduction of a common PC in this area would ensure a level playing field among companies.

We support the approach to common resilience measures. Regarding the options presented for a wastewater resilience measure (page 59, table 4.2) we think that Option 1 – Percentage of the population served by a wastewater system at risk of flooding – is the most appropriate, as this is an Outcome measure.

We consider that it would be beneficial to review each of the proposed common PCs and to consider firstly whether or not they are monitored independently by a quality regulator and secondly whether they would benefit from the kind of consistency/convergence work that has already been applied to sewer flooding, interruptions to supply and leakage. We would advocate such an approach for any measure that is going to be used for making comparisons across the industry. In addition to ensuring that measures are consistent, something we have long championed, we believe that all of the data relating to common PCs should be independently audited to demonstrate compliance (as companies are required to do with their finances). Such an approach would build on the valuable consistency work that was initiated at PR14 through the horizontal audits approach. Finally, we would note we disagree with the proposal use of 'per capita consumption' as a measure. This is a subjective measure that relies on an estimate of occupancy. Instead we would support the use of 'per household consumption'. This is a much more appropriate and objective measure because companies have robust data about the number of households they serve.

Q1b: Do you agree with our approach to asset health outcomes?

Agree

We support the proposed approach to asset health performance commitments.

We agree that a measure of bursts is appropriate to measure asset health for water network assets. We are concerned that the current definition of this measure essentially monitors bursts found and fixed. This would potentially penalise companies that increase their focus on finding and fixing leaks in order to improve leakage performance. We would welcome a refinement of the definition so that this measure tracks 'reactive' bursts only.

We agree with the use of a measure of environmental impact to determine asset health for wastewater above ground assets. We do not think that Category 4 pollution incidents should be included in this measure, as by definition these have 'No Impact' on the environment.

We agree with the approach of complementing the common measures for asset health by selecting additional measures from either the proposed long list, or by defining bespoke measures.

We would welcome clarity on whether the proposed sewer network asset health measure is collapses or blockages. Page 56 refers to the former, page 61 to the latter.

Q1c Do you agree with our approach to bespoke PCs including areas that bespoke PCs should cover?

Agree

We agree with the proposal that companies should set bespoke PCs, with clear definitions, linked to the areas that customers most value. We support the list of areas that companies should cover with their bespoke PCs (page 63, table 4.3).

Q2: Do you agree with our proposals on setting performance commitment levels?

Strongly disagree

We have significant concerns about the proposals. In our view it is extremely difficult to see how the upper end of the RORE reward range (+3%) could ever be achieved in practice as it is only available in extremely stretching circumstances, where companies deliver step changes in performance across all of their performance commitments. Furthermore, a company that achieves upper quartile performance for some measures, and average performance for others, could be in overall penalty. This for us demonstrates that, as currently proposed, the balance between risk and reward is not set at the right point.

We also have significant concerns about performance commitments being set at projected 2024-25 upper quartile levels and expecting companies to achieve these levels in the first year. This is particularly the case for the four key measures, where the combination of setting performance commitments six years in advance, making them applicable from 2020 and penalising for average performance, makes the prospect of achieving meaningful rewards very unlikely. For the other measures, both common and bespoke, with average performance likely to incur penalties, an aggregated reward of +3% of RORE is almost impossible to achieve.

Q2a: Do you agree with our proposals to setting bespoke performance commitment levels?

Strongly agree

We are very supportive of basing performance commitments on a broader set of evidence than was used at PR14, as set out in table 4.4 (page 66). We think it is important to acknowledge that such an approach will require companies to exercise a higher degree of judgement than was previously the case; as such we welcome the reference to CCG involvement to assure this.

Q2b: Do you agree with our proposals to setting common performance commitment levels?

Strongly disagree

Consistent with our response to Question 2, we have significant concerns about the proposed approach of setting performance commitments at projected 2024-25 upper quartile levels and expecting companies to achieve these levels in 2020-21. We understand from the draft methodology that projected 2024-25 upper quartile performance levels will be applied to the four specified common performance commitments. The draft methodology also implies for other measures that companies should use comparative information to look at the upper quartile level of performance and forecast it for the 2024-25 proposed PCs. We strongly disagree with this approach. Upper quartile performance is very difficult to forecast six or more years in advance and many proposed measures are not yet the subject of single and audited measurement methodologies.

We do not understand the logic of incentivising performance relative to a forecast upper quartile 2024-25 performance from the start of the AMP. In our view, companies should earn rewards for being upper quartile in each year. As such, it would be better to apply rewards to the upper quartile performance on a year-by-year basis, with the level being reset every year according to the best performance across the sector.

In addition, the combination of setting performance commitments six years in advance, making them applicable from 2020 and penalising for average performance, makes the prospect of achieving rewards with a RORE value approaching 3% very unlikely even for an exceptional company.

Finally we think that there should be a transition period to reach upper quartile on the water quality compliance measure (CRI). It is a new measure so there is no starting position to act as a reference point; it will therefore take time for the measure to bed in and for companies to develop improvement plans. This approach should also apply to any other new measures.

Q2c: Do you agree with our proposals to setting leakage performance commitment levels?

Neither agree nor disagree – N/A

We agree that while SELL is a helpful reference point, it has its limitations. In particular relying on the SELL means that future leakage targets are determined by current-day economics. A more appropriate approach in the long term would be for targets to be driven by customer and stakeholder views and for companies then to work out how best to reach those targets in the most economical way. We therefore support the proposal to encourage innovation, particularly with regard to identifying more efficient ways to control leakage.

While we support setting stretching commitment levels on leakage, we note that it will be much more difficult for higher performing companies (ie those already performing beyond upper quartile) to achieve a 15%

reduction. These companies could reasonably argue that achieving a 15% reduction while already achieving upper quartile is not appropriate.

Q3: Do you agree with our proposals for strengthening outcome delivery incentives?

Agree

We are broadly supportive of the overall proposals.

We agree with the points made regarding the importance of the reputational impacts of ODIs. We also agree that it would be beneficial to strengthen existing channels for publishing comparative information (ie Discover Water).

In our view, rewards and penalties should be available for asset health performance ODIs, as they are with other performance areas.

We agree with the proposals relating to ODI design (section 4.4.6).

Q3a: Do you agree with our proposals to increase the strength of ODIs by increasing the impact ODIs have on reputation, the greater use of in-period ODIs, linking ODIs to revenue rather than RCV and having a greater onus on financial ODIs?

Agree

We agree with the proposals.

Q3b: Do you agree with our proposals on enhanced rewards and penalties?

Strongly disagree

Although we strongly support the concept of enhanced incentives, we strongly disagree (as indicated in appendix 2, section 3.3) that companies already at the frontier should need to achieve a level of improvement greater than that achieved historically to qualify for enhanced rewards, for the following reasons:

- This approach does not mimic the way that companies would be incentivised in a competitive market – leading companies achieve enhanced rewards without reference to their rate of improvement to past performance, which is irrelevant.
- By requiring companies to aim for an improvement greater than historical improvements for that metric, Ofwat is requiring leading companies not only to stretch the frontier, but to do so at a faster rate than previously.
- We are concerned that this constraint could nullify the incentive properties of the enhanced rewards. We are surprised Ofwat have adopted this cautious approach.

Q3c: Do you agree with our proposal to remove the RoRE cap?

Agree

We agree with the proposal to remove the RORE cap. Given our observations elsewhere in relation to questions two and three, however, we think it unlikely that achievable rewards beyond the current cap will apply in practice based on the draft methodology.

Q4: Do you agree with our proposed Customer Measure of Experience (C-MeX)?

Agree

We welcome the on-going focus in this area and feel that it is imperative that the ways in which the customer experience is measured, continue to evolve.

The introduction of the C-MeX as part of the new overall WaterwoCX measure is a welcome step forward. We are also pleased to see that the overall measure includes D-MeX, which recognises that developers are an important body of customers.

As a critical metric for the water industry and its customers, it is important that this will be a common performance measure. We agree that it should be across the retail and wholesale parts of the value chain.

We also agree that C-MeX should comprise components relating to transactional and perception based customer satisfaction. This will ensure that we capture the views of those customers who choose to contact us and of those who do not (the 'silent satisfied majority').

We agree that complaints should include those that are made using channels other than the traditional telephone, written or email when the customer can be identified and is happy for this to happen. We welcome the direction to offer more contact channels for customers. Our company is currently investing in a new industry-leading customer experience platform, as used by the likes of Apple, which will provide customers with increased channel choice and a seamless experience across all of the contact channels we offer. The new platform will be fully integrated into our new Customer Care and Billing System, which will then enable a greater degree of personalisation of service and a consistently high service across all contact channels.

We welcome the increased reward potential for C-MeX and think it is important that the water sector is benchmarked against broader customer service providers. In the co-creation of Our Unrivalled Customer Experience Strategy our customers, employees and supply partners all stressed the importance of measuring our performance against the best customer service organisations such as Amazon, John Lewis and Apple. As such our strategy clearly states our aspiration to at least match these organisations' customer service levels.

We also feel it is right that we are provided the opportunity to increase rewards should our customers rate us among the best customer service providers they experience, from all sectors.

We have concerns about the use of UKCSI in benchmarking, even as the mechanism for determining upper quartile performance. We would question the robustness of the methodology that is used for the UKCSI survey as it relies on customers to choose whether they wish to provide feedback on organisations. The results may not be reliable and, in our experience and that of other companies, can be volatile and inconsistent when compared with other measures of customer satisfaction, including Net Promoter Score (NPS). It is important that any methodology is statistically robust and we do not think that the UKCSI meets that challenge.

We would also like to understand further how UKCSI could be used to assess whether or not C-MeX performance corresponds to an upper quartile customer service industry performance as measured by UKCSI. In our view this would not be practical to implement (as outlined in section 4.5.2, page 82 of the draft methodology). We consider that NPS would be a simple, more transparent measure for benchmarking across the whole customer service industry. We believe NPS is well understood. We have been collecting information on the measure, for both experience and perception purposes, as part of our quarterly domestic tracking research for some time. This allows us to compare our NPS with companies outside of our sector. NPS could easily be collected as part of the customer experience and customer service surveys.

We believe that the most reliable way to obtain customer feedback is through telephone surveys, although the use of SMS has also been effective. In our experience online surveys suffer very low response rates and take time to complete to an acceptable and representative level. This experience has been gained when

undertaking our business benchmarking surveys through our Institute of Customer Service (ICS) membership.

We also believe that the growing mistrust of email (reinforced by recent problems with ransomware and virusware) will cause issues with online survey completion, as customers become reluctant to respond to unsolicited emails. Companies will also typically hold email addresses for only a proportion of their customers and while these numbers are likely to be increasing across the sector, any online survey would still exclude those customers whose preferences are not to use email or online channels for contact.

In summary we believe the move to C-MeX is very positive and support the application of Option 1 subject to the following points being considered:

- The customer service (contact) survey should not be done online.
- The mechanism for benchmarking service across the whole customer service industry would be better achieved through the use of NPS, not UKCSI.
- The surveys would benefit from larger sample sizes and this can easily be achieved with the use of low cost SMS (although this would exclude some customers who do not use mobile technology).
- It is important to remove any opportunity to apply subjective decisions that might influence the samples for survey.

Q4a: Do you agree with our proposed methodology for the C-Mex surveys, as set out in table 4.2 of Appendix 2?

Agree

We broadly agree with the proposed methodology for the C-MeX surveys as set out in table 4.2 of Appendix 2, subject to the comments below (Q4b).

Q4b: Do you agree with the C-Mex contact survey focusing on customer satisfaction with both contact handling and resolution?

Agree

When considering the customer service (contact) survey we believe it is important to retain the sample as all inbound contacts. While the focus of the survey is handling and resolution – and not all contacts will be resolved – we believe this is not a major concern. Our preference is not to introduce any subjectivity relating to whether or not a company considers a contact resolved as this could be open to a variety of interpretations.

We note that table 4.2 and the following text on page 91 proposes a change in the satisfaction scoring (with 1 being very satisfied and 5 being very dissatisfied). This is the opposite of the current approach; our preference is to retain the rating scale as it is currently (ie 1 being very dissatisfied and 5 being very satisfied).

We believe that online surveys should be avoided. We support the continued use of telephone surveys or failing this the use of an SMS based survey for the customer service (contact) survey. In line with best practice we currently limit our SMS surveys to two questions.

We agree that surveys should be equally weighted across billing and operational contacts.

For the customer experience (non-contact) survey we agree that a random sample of bill payers should be used. We would recommend that rules are introduced to prevent the same bill payer being surveyed too frequently. If a bill payer is surveyed they should not be surveyed again for a minimum of one year. We would also suggest that customers who are served by more than one water company should be told up-front that the survey is specifically about one service provider, not the other. Responses should be filtered out in instances where the customer makes reference to both companies, or to the other company that is not the subject of the survey.

We agree that surveys should be undertaken by an independent third party. We believe the sample size could be increased, particularly if using SMS as a channel for surveys. The increase in sample size will also help remove some of the volatility we see across the current measure.

We suggest that the proposed definition of bill payers is revisited as it could be misinterpreted by customers. In many cases we will have more than one name on our accounts for each household. The stipulation of surveying the bill payer only may result in reduced success rates for surveys.

We are concerned that the redefinition of complaints including telephone complaints could be subjective. We agree that complaints that are identifiable and can be recorded as being from one of our customers and received via social media should be included. It may be prudent to identify these separately from written and telephone complaints so as not to influence behaviours that limit the use of social media and other new contact channels that our customers may wish to use.

We would make the general point that wherever information is going to be used to make comparisons across the industry (such as for example the number of complaints) then any definitions or categorisations must be agreed, clearly understood and applied in a consistent way by all companies.

Finally, we support making C-MeX an in-period, annual financial incentive. We agree that this will strengthen incentives for companies to improve the customer experience.

Q5: Do you agree with our proposed Developer Measure of Experience (D-MeX)?

Agree

We agree that needs differ between different categories of customers and we support proposals to introduce a robust and workable measure of developer services customer experience. It will be important that any results that are submitted against this measure are subject to independent audit.

Q5a: Do you agree with our proposed approach to implementing D-MeX, in particular by conducting a satisfaction survey amongst past developer services customer contacts?

Agree

We support the preferred option to establish a D-MeX task and finish group of developer services customers and water companies to explore further how best to develop and implement a regular satisfaction survey that could be compared across companies.

To be most effective the group should include the widest possible range of developers, self-lay providers and representatives from new appointments and variations. This will ensure that qualitative reporting metrics are robust and reflect what our customers consider to be key in measuring their experience.

We believe that customer satisfaction measures will drive further service improvements beyond those already achieved by introducing the quantitative Developers' Charter measures. They can also be used to drive change across quantitative measures to ensure that reporting metrics are both robust and a true reflection of what our customers see as being important.

We support the proposal to apply rewards and penalties for the best and worst performers and setting incentives at a level of 5% of annual developer services revenue.

Securing long-term resilience

Q1: Do you agree with our resilience planning principles?

Agree

We support the seven resilience principles that are set out in the draft methodology.

We agree that resilience in the round and for the long-term is a good way to demonstrate a systematic, integrated and business-wide understanding of service and systems risk. It also reflects the interdependencies across corporate, financial and operational aspects of the business.

We agree that the principles have been clarified by distinguishing between risk and resilience, and by emphasising the role of the environment in sustaining the resilience of systems and services.

We would make an additional point, which is not directly addressed in the draft methodology, that any enhancements to resilience that require additional investment would need to be supported by our customers, and the required investment reflected in the cost allowance.

Q2: Do you agree with our approach to assessing resilience in the initial assessment of plans?

Agree

We generally support the proposed approach to the initial assessment of business plans and how this relates to securing resilience in the round and for the long-term.

We agree that the assessment tests should take into account the extent to which companies have applied the resilience planning principles.

We agree that an ambitious and innovative plan will present strong evidence that supports approaches to partnerships, markets and catchment management in combination with fixed asset based solutions.

We recognise the need to develop simple, robust and transparent resilience measures that can be used to measure current resilience levels and to drive improvements. This will require a great deal more work and collaboration across a number of different partners (building on existing work in this area, such as the current trialling project led by Water UK). As such a realistic target might be to introduce better measures from 2020.

The draft methodology includes a proposed set of common resilience performance commitments. Of the wastewater measures we prefer Option 1 – percentage of the population served by a wastewater system at risk of flooding. This is the nearest to an outcome measure, with the others closer to outputs.

We agree that it is necessary to assess the extent to which customers are at the heart of the process throughout and understand the link with the principles of good customer engagement.

We support the inclusion of a test that assesses the value for money provided by resilience mitigation options. We also support the way in which this is set out in principles 4 and 5.

The draft methodology references many aspects of resilience (working in partnership, rapid technological change, skills gaps, using markets, innovation). We agree that all of these aspects, and many others, will need to be addressed in business plans.

We support the approach to allow for efficient investment in resilience through the cost assessment process. Customers must have trust and confidence that they are being served by efficient companies that demonstrate long-term financial viability and are operating with strong governance and assurance processes in place.

Targeted controls, markets and innovation: wholesale controls

Q1: Do you agree with our proposals for the form of control for network plus water and network plus wastewater set out in the 'Wholesale controls' chapter and appendix 7, 'Wholesale revenue incentives'?

Agree

We support the building blocks approach to determine total revenue. This will help all stakeholders to recognise that the network plus control is essentially unchanged from PR14.

We would welcome clarification as to the status of investment in the network plus RCV. While the draft methodology is very clear that water resource and bioresources investments post 2020 are not protected from risk, Appendix 7 does not appear to address the status of post 2020 investment in network plus RCV explicitly.

Investors in the industry place a strong emphasis on the RCV and the protected status of parts of the RCV will be an important factor in their decisions. We would urge Ofwat to explicitly reaffirm that the network plus RCV is not at risk.

Developer services – Appendix 7, Section 4.1

We welcome the recognition that the current regulatory approach does not provide appropriate incentives for companies to encourage new development.

Our preference is for Option 2 – developer services treated outside the revenue control. Certainly, contestable services could be excluded from the control as competitive pressure will maintain efficiency incentives. Charges for non-contestable service are required to match network costs and so will be visible and challengeable under current proposals in Ofwat's developer charging guidance.

While Option 3 – end period volume forecasting – is preferable to the current approach, it adds complexity. It is notoriously difficult to forecast house building activity up to five years ahead, so we welcome the use of a deadband for the forecasting incentive. Our preference is therefore for Option 2, to completely remove developer revenues and costs from the price control.

We have set out below our views on the options outlined in Appendix 7:

Section 4.2.3: We support the continuation of the in-period revenue adjustment and financial incentive. We understand that this is in line with the current wholesale revenue forecasting incentive mechanism (WRFIM) methodology and requires the licence change that we recently accepted. We suggest that the tolerance range for this should remain at current levels.

Section 4.3.3: We support Option 2 to retain existing incentives for new water trades. We intend to publish our own trading and procurement code before September 2018. We have carried out a significant water trade over 2015-20 and we intend to apply for an incentive allowance for this.

Q2: Do you agree with our proposals for the form of control for water resources as set out in the 'Wholesale controls' chapter and appendix 5, 'Water resources control'?

Disagree

We support the 'bidding in' approach to creating a market for the provision of new water resources. This is an efficient way to make sure that the best value water resources are procured in the future. It also aligns with the Water Resources Management Plan (WRMP) process.

We note that the draft methodology suggests that the English bilateral market would only be expected to open in the later part of the 2020-25 period, and that the market during this period is likely to be small and

nascent. With this in mind, we believe that the bilateral market should be designed after the necessary legislation has been passed (ie at PR24), not beforehand.

Q3: Do you agree with our proposals for access pricing for English water companies set out in the 'Wholesale controls' chapter and appendix 5, 'Water resources control'?

Agree

We have set out below our views on the options outlined in Appendix 5:

Section 4.1.3: We support Option 2, the proposal to charge water resources to retailers rather than wholesalers. This adds transparency and is consistent with the separate water resource control.

Section 4.2.3: We support Option 2, the indirect link between PR19 and access pricing.

Section 4.3.3: We agree that Option 1, water resources yield, is the only capacity measure that reflects water resources alone.

Section 4.4.2: We support Option 1, the retention of the building blocks approach with an adjustment mechanism for post 2020 investment. We agree that a new approach based on unit costs would be disproportionate at this stage.

Section 4.5.1: We support Option 2, using a capacity measure for bilateral market entry adjustment. As the draft methodology notes, it is difficult to disentangle market-wide demand effects from the impact of bilateral entry.

Section 4.6.2: We would be concerned that mandating companies to bear utilisation risks relating to market wide demand could create a disincentive for large scale, long-term resource enhancements. These schemes may well be the most efficient long-term resource schemes; however, the shorter term risk of temporary underuse could drive companies to choose less efficient schemes that provide smaller resource increments, thus minimising their risk. We therefore welcome the preference stated in the methodology for Option 1, where companies identify their own risk sharing arrangements.

Q4: Do you agree with the proposals for company bid assessment frameworks set out in appendix 9, 'Company bid assessment frameworks: the principles'?

Agree

We agree with the proposals.

Q5: Do you agree with our proposals for the form of control for bioresources as set out in the 'Wholesale controls' chapter and appendix 6, 'Bioresources control'?

Strongly agree

We agree that an average revenue control using tonnes of dry solids (TDS) as the volume measure is the most appropriate approach. We also support the exclusion of cost sharing from this control, as the average revenue control will largely address this.

With this in mind, it is important that the cost assessment for bioresources is based primarily on a TDS cost driver. Any mismatch between the drivers of revenue and of costs risks windfall gains or losses that result from divergence between the drivers rather than from actual performance.

We believe that aligning the two should also encourage forecasting accuracy, as it removes any incentive to under- or over-forecast TDS volumes. With this in mind, we prefer Option 1 in Section 4.1.2, although our next preference is for Option 3 – Volume forecasting incentive. We agree that there should be a deadband, to allow for more accurate measurement. We also support the proposal to calculate the variance over the full five years rather than annually. This is important, as it will ensure that temporary variations due to maintenance, inventory changes and even weather variations can be smoothed out.

Finally, we suggest that the volume of TDS from new trades over 2020-25 should be excluded from the Actual TDS in the forecasting incentive calculation to ensure that there is no disincentive for trading. The nature of a dynamic market is that trades cannot be forecast five years in advance, so they should be removed from the calculations.

We have set out below our views on the options outlined in Appendix 6:

Section 4.2.2: We support Option 1 – simple revenue correction mechanism – as this should allow for corrections for variations from previous years. A revenue incentive mechanism would be disproportionate for what should be relatively minor variations and could even be a disincentive for innovative bioresources tariffs.

Section 4.3.1: We believe that allowing companies to retain 100% of the benefits of bioresources trading up to the next price control period is a necessary incentive to encourage the development of the bioresources market. To apply Option 2 – in-period profit sharing – seems to us to dampen the incentives for trading. We are also not clear how information interactions between the appointed business and the bioresources trader would work, as profit margins made outside the appointed business are commercially confidential.

Targeted controls, markets and innovation: direct procurement for customers

Q1: Do you agree with our draft guidance that appointees should focus on projects likely to deliver the greatest customer value for DPC at PR19? (We ask that appointees provide a list and description of which projects, based on our guidance, they consider would be in scope at PR19.)

Agree

We agree that these are the most appropriate projects to consider, as they would be of a sufficiently large scale to warrant the tendering and contractual set up costs that such projects entail.

At this stage, we do not envisage having any 2020-25 discrete, large-scale enhancement projects expected to cost more than £100m based on whole life totex. However, we intend to incorporate the aims and principles behind DPC in our own approach to procurement, and will explain this further in our business plan submission next year.

We believe it is critical for there should be equal regulatory treatment between direct procurement and conventional schemes to ensure that the most efficient scheme is delivered. With that in mind, direct procurement projects should have the same regulatory challenge (cost assessment, utilisation incentives) that apply to conventional schemes.

Q2: What are your views on the type of tender model (ie an early or late tender model) appointees should use? Do you have any views on whether or not we need to specify a tender model companies should use?

Neither agree nor disagree – N/A

For DPC investment, we envisage a delivery model whereby feasibility studies, initial designs, surveys and studies, planning consents, and community and stakeholder engagement are completed before commencing the bidding process. This approach would enable bidders to better complete their due diligence. It would also allow for better definition of contract principles, improved risk assessment and apportionment between the contracting partners. In our view this would result in the most economically advantageous offer and best value solution being delivered.

This approach would necessitate the application of a 'Late' model approach to the procurement of the DPC. We recognise the potential disadvantages of such an approach, particularly that it may restrict areas of innovation in the development of solutions. However, we believe that the advantages of delivering significant savings remain critical to the success of any DPC.

Overall, we believe that there is no need for a tender model to be specified, as leaving this open gives each company and DPC contractor the greatest flexibility over the approach taken.

Q3: What are your views on the overall commercial and regulatory model, including our draft procurement and contract principles set out in appendix 10, 'Direct procurement for customers'?

Neither agree nor disagree – N/A

Our current procurement approach is to deliver solutions using D&B models based on pre-defined procurement templates that reflect the value and risk associated with each investment. These arrangements are typically delivered in a partnership founded on incentivised commercial terms. Our arrangements, consistent with the strategic objectives of the UK Government's Construction Strategy, are based on:

- operating as an expert client, confirming and prioritising business need and the outcomes required;
- providing programme visibility and commitment to chosen delivery partners;
- developing appropriate and meaningful early contractor involvement that provides appropriate commercial models that incentivise delivery; and
- providing a collaborative yet challenging environment that creates the right incentives for innovation and performance.

We believe that the opportunities of direct procurement are consistent with our existing strategy whereby high value projects are competitively tendered separately outside of our partnership delivery arrangements (and in accordance with The Utilities Contracts Regulations 2016).

The draft principles (Table 4) for DPC are consistent with our existing arrangements.

Overall, we believe that this is an area that will develop over time. Indeed, it does not seem necessary that all arrangements are set out in advance of setting price controls. We therefore suggest that licence changes to enable DPC could be made separately from the price control, while any guidance on the procurement process could evolve over time, as lessons are learned.

Targeted controls, markets and innovation: retail controls

Q1: Do you agree with using a weighted average revenue control, where appropriate taking account of different costs by customer type for the residential retail price controls for English and Welsh water companies?

Strongly agree

We support the continued use of a weighted average revenue control. We know that retail costs are higher for combined service customers than they are for single service customers but expect that the more complex econometric approach to cost assessment will take this into account. The revenue controls by customer types should be directed by the structure and results of the cost assessment models.

Q2: Do you agree with using an average revenue control for business retail price controls for Welsh companies not subject to competition?

Neither agree nor disagree – N/A

This question does not apply to our company.

Q3: Do you support price controls for business retail activities for English water companies that have not exited the business retail market?

Agree

We have exited the business retail market. In our view however in order to maintain a level playing field it is appropriate to retain price controls for non-exited business retailers that match the controls set in the retail codes of retailers that have exited the market.

It would also be helpful to know whether the next retail price control period would be for two years (so that the reviews become synchronised again) or would continue along a separate timescale.

Q4: Do you support price controls for water service customers of Welsh companies using more than 50 megalitres a year?

Neither agree nor disagree – N/A

This question does not apply to our company.

Q5: Do you support a three year price control for residential retail activities and business retail activities?

Agree

We understand that the retail control does not need to be the same length as the wholesale control, so are comfortable in principle with the proposals. If there were to be a significant legislative change, such as residential competition, or one that affects the legal status of water bill debt then this would be best considered as soon as possible.

Our only concern is that the proposal would disconnect the retail price review from the wholesale price review. It is not clear to us how requirements that refer to the whole appointed business, such as Ofwat's financeability duty, would work in these circumstances. The PR16 control for non-household retail was set with the assumption of the same level of overall revenue, so could be carried out without an associated financeability check.

Finally, it would also be helpful to know whether the next retail price control period would be for two years (so that the reviews become synchronised again) or would continue along a separate timescale.

Securing cost efficiency

Q1: Do you agree with our overall approach to cost assessment?

Neither agree nor disagree – N/A

As we have not yet seen the cost assessment models, we are not currently in a position to agree or disagree with the approach. We do have concerns over the timing of the models being released, for the following reasons.

We are concerned that the requirement for cost adjustment claims is set four months before the business plans submission deadline and is required before companies have seen the cost assessment models to which the adjustments will apply.

We are also concerned that, if the models are not released until January 2019, this will generate a large amount of work for companies and for Ofwat over 2019.

The definition of 'special factors' is that they are adjustments for circumstances beyond a company's control that the cost assessment models do not capture. It is therefore extremely difficult to assess what these might be without seeing the cost assessment models. While we will make best endeavours to set out any

adjustments we feel may apply, it will be almost impossible to quantify these with any certainty without using the models. We are comfortable with the early submission being used as a way to set out possible areas for special factors. However, we do feel that companies should be able to adjust these when the models are released.

Bioresources Cost Assessment (see also Q5, Wholesale Cost Controls)

We agree that an average revenue control using TDS as the volume measure is the most appropriate approach. We also support the exclusion of cost sharing from this control, as the average revenue control will address this.

With this in mind, it is very important that the cost assessment for bioresources is based primarily on a TDS cost driver. Any mismatch between the drivers of revenue and of costs risks windfall gains or losses that result from divergence between the drivers rather than from actual performance. We believe that aligning revenues and costs should also encourage forecasting accuracy, as it removes any incentive to under- or over-forecast TDS volumes.

Q2: Do you agree with our proposed cost sharing incentive? We welcome thoughts on the calibration of the incentive

Disagree

We agree that an efficient company should have a high incentive rate both as a reward and as an incentive to continue to push the efficiency frontier. In that context, we agree with the increased outperform incentive rate of up to 60% and we believe that we are likely to be in that position for PR19.

We do have some concerns about the proposals for asymmetric cost sharing rates for underperformance. The effect of the asymmetry is that inefficient companies are incentivised to submit a low business plan totex figure, rather than an accurate one.

Our concern is that an inefficient company's optimal strategy may be to submit a business plan totex level that it knows is unachievable, so that it receives a low cost sharing rate that applies when it inevitably underperforms. This would not be in customers' interests, as 60% of that 2020-25 underperformance could be applied to their bills in 2025, creating a sharp increase in their bills.

To illustrate the incentive, an inefficient company that knows it will deliver totex of 120 is still incentivised to submit a business plan totex of 80, to receive the minimal cost sharing rate of 40%, so it only loses 8% of totex rather than the 12% penalty it would have received if it had made a more accurate forecast. The balance is applied to customers' bills, who are then worse off because of a forecasting error by the inefficient company.

We would therefore suggest that the underperform incentive rate is considered again and that it is set at either a flat rate or at the same rate as the outperform rate.

Finally, we note that two options on cashflows are being considered – Option 1: setting them at the Ofwat view of efficient totex or Option 2: reflecting the position that cashflow in the PR19 determination is consistent with the business plan. We favour Option 1, on the grounds that it will minimise bill volatility.

To illustrate this, under Option 2, if a company does not deliver the level of totex set out in its business plan the end of period adjustment will have to be an upwards impact on bills. It will be difficult for customers to understand why their bills are rising due to a company missing its own business plan targets.

Option 1 under the same circumstances would set bills on a baseline assumption, ignoring the business plan proposals. Bills would only be adjusted at the end of the period to reflect actual delivery against the baseline, which is much easier for customers to understand.

Q3: Do you agree with our proposals to funding unconfirmed environmental requirements? Which of the two options do you consider is more appropriate, and why?

Agree

We agree that the mismatch between the PR19 control period and the river basement management plan (RBMP) cycle can cause difficulties when trying to identify required environmental outputs over 2020-25.

Overall we favour Option 2 (Appendix 12) – allowance for a proportion of the anticipated programme. This approach recognises that it is possible that all of the schemes that are initially identified may be required, but a conservative approach is taken over the assumed timing.

Option 4 – linking to outcomes and unit costs – would in our view be overly complex, would not take account of specific circumstances and would have weak incentives for any challenges on the scope and scale of the programme.

We estimate that, on a pro-rata basis, just over half (3.25 years out of six) of the RBMP period would be covered by the 2020-25 period. We also agree that an allowance for transitional expenditure in 2024-25 should ensure that companies have sufficient time to deliver post 2025 schemes.

Provided this approach can be agreed with the Environment Agency, we feel this would be the best approach for all stakeholders. It is important that Ofwat's approach aligns with the EA's Water Industry National Environment Programme (WINEP) guidance as set out in 'PR19 planning – traffic light system for identifying measures for the Water Industry National Environment Programme'.

Our proposed approach is that all 'Green' schemes would be included in our plan with a set of rules developed to agree which schemes should be included from the Amber category.

Depending on the driver, these rules could reflect the level of certainty (by WINEP3), and the cost/benefit of the scheme.

Q4: Do you agree with our approach to cost adjustment and our proposed approach to make the process more symmetric?

Agree

We understand that there may be occasions where a downwards adjustment to the model may be appropriate as a consequence of an upwards adjustment for one company. A model that includes such costs should indeed be recalibrated should there be external cost adjustments. We do suggest there should be a materiality level for these adjustments, and that all companies should have the time and opportunity to challenge any such adjustments and to provide additional evidence.

The example provided of adjustments for regional labour costs is problematic in our view. All companies will have different regional labour costs, so a more appropriate approach would be to include this in the model.

It is also important to allow companies time to review cost adjustments to consider whether they also apply to them.

The overall process would be improved if the cost models were published as early as possible and if cost adjustment submissions were made transparent to all parties.

Q5: Do you agree with our proposed approach for assessing retail (residential and business) costs at PR19?

Strongly agree

We support the use of an econometric approach to benchmark company costs and set efficient baselines. We particularly support the incorporation of factors such as bill size and deprivation, as these are both significant in the assessment of bad debt levels.

The creation of separate benchmarking models for bad debt costs from the rest of retail costs seems appropriate, as the cost drivers are very different in our view.

Q6: Do you agree with our preferred approach not to index the retail controls to a measure of general inflation, and, if appropriate, deal with input price pressure as part of our totex allowance?

Agree

We understand the reasoning behind the proposal not to automatically index retail costs by RPI, and agree that there should be a mechanism to deal with input price pressure. Increases in labour costs, for example, are often determined by increases in wider regional labour market wage rates. In seeking to attract staff, companies are not able to control these wider costs.

We believe there should be a single model or template for input price pressure submissions. It would not be efficient for Ofwat to have to assess multiple different forms of proposals from companies, with different methodologies.

Q7: Do you agree with our proposals for the transition programme?

Agree

We agree that a transition programme may be required for 2019-20, and that this should be on a relatively small scale. We also agree that it seems unlikely that there would be transition expenditure on water resources and bioresources. However, we suggest that the option is retained for companies to make the case, on an exceptions basis.

Aligning risk and return

Q1: Do you agree with our proposed approach to setting the cost of equity, based on the best estimate of expected returns in the 2020-25 period?

Strongly disagree

We have significant concerns about the approach proposed in setting the cost of equity. The PwC report Appendix B is particularly important in this context and we have addressed some of the points here.

Interest Rates – "Lower for Longer" does not mean lower Total Market Returns

The PwC report Appendix B starts by noting that interest rates are forecast to remain low in the foreseeable future. However, forecasts can change quickly and the reason for introducing indexation of the cost of new debt is because of the difficulty in forecasting interest rates.

Notwithstanding this, we do not believe that low interest rates should on their own suggest there should be reductions in total market returns. PwC's evidence (page 78) supports a negative correlation between the Equity Risk Premium and the Risk Free Rate, so it would be wrong to use a reduction in the risk free rate to imply a reduction in total market returns.

The premise of PwC's proposal that lower interest rates for longer will cause total market returns to be lower in PR19 is therefore flawed. Total market returns must be calculated through direct observation rather than through adjusting one component without considering the other.

There are a number of risks with using current 'spot' total market returns estimates

Figure 25 of the PwC report is important in the debate over whether a spot estimate of TMR is more appropriate than one over the longer term.

Short-term estimates of TMR are volatile. This is illustrated by year on year ex post achieved returns, which show marked volatility over time. In Figure 25, spot estimates using Dividend Discount Model (DDM) of nominal TMR range from c.7.9% in 2010 to 12.1% in 2009.

The PwC estimated nominal TMR range is from 8% to 8.5% (Appendix C). Reference is made to the spot rate at December 2016 of 8.3%, with a five-year average of 8.8% (Figure 25).

We are surprised that PwC has set the recommended TMR range around a spot rate rather than the more stable and consistent five-year average. It is particularly surprising given that the PwC report itself states ***"we caution against relying on any particular spot estimate given the inherent volatility of these approaches."*** (page 81).

As a further reason to use a longer term figure rather than a spot rate, DDM outputs are highly sensitive to the time period and dividend growth assumptions. Increasing dividend growth by a small amount, for example, would increase TMR significantly.

Finally, using short-term estimates is inconsistent with regulatory precedent – as Table 12 notes, all recent regulatory decisions have used long-term TMR estimates of c.6.5% real.

It is inappropriate, and both a major change in approach and a break from established precedent, to disregard historical data. The traditional regulatory approach has been to use long-term data, resulting in very stable estimates of the cost of equity over time.

The long-run ex post data is what investors actually received in the past and therefore has the benefit of not being affected by assumptions/forecasts.

Long-run data provides an inherent allowance for uncertainty and embeds lessons learnt from past.

RCV premia based estimates of TMR

In Table 15, there are further estimates of TMR based on RCV premiums for Severn Trent Water and United Utilities as at 31/3/2016. These are in the range 7.6% to 8.1%. We believe that the majority of the market to asset premium for these companies is attributable to RCV growth and outperformance over 2015-20. This outperformance is addressed by the PR19 adjustments to the cost of debt, capturing of tax rate reductions and the resetting of the totex cost assessment baseline.

Forthcoming KPMG report

We will be publishing a report by KPMG on these issues by early September, in partnership with Anglian Water and Affinity Water. We would welcome the opportunity to follow up this report with Ofwat once it has been considered.

Q2: Do you agree with our approach to indexing the cost of new debt?

Neither agree nor disagree – N/A

We broadly agree with the approach as set out. We particularly welcome the proposals to index the cost of new debt only and to adjust for the long-term view of inflation in the index (Option 2 of Appendix 13). We support using the iBoXX for new debt indexation as it is the most relevant and reliable index available. We do have a concern over the assumed proportion of new debt, which we explain later.

We would be concerned if any over-prescriptive use of an index led the industry to focus simply on trying to match the index. If this led to sub-optimal costs of debt, this would be detrimental to customers. For this reason, we welcome the proposal to set a fixed allowance for embedded debt based on company benchmark data. This will retain the freedom companies have in choosing their sources and types of financing.

In using the IBoXX for new debt, we have considered how closely Ofwat assumptions match up to current practices. Our main concern is over the suggestion that the proportion of new debt for 2020-25 will be 25% on average. This would mean that 50% of debt by 2025 was new debt (ie issued over 2020-25). A review of company debt tenor from recent Regulatory Accounts suggests that refinancing from debt due in less than five years is at most 25% of total debt. To this would be added new debt (not refinancing) due to RCV growth. We are not convinced that this would equate to a further 25% of total debt. Many companies are experiencing low or zero real RCV growth, and we expect this trend to continue into 2020-25.

This suggests that assuming the proportion of new debt by 2025 to be 50% would be an overstatement. This is important, as using it would overstate the balance of the new/embedded debt allowance, and any subsequent adjustments for new debt costs.

The projected mix of the new/embedded debt can easily be confirmed by Ofwat when it reviews the business plans submitted in September 2018. We urge Ofwat to revisit the new/embedded mix assumption in the light of this data when it is received.

Finally, we note that the cost of debt includes several items that are not included in the yields from the iBoXX, namely:

- new-issuance premium on any bonds;
- fees on debt;
- standby/overdraft/capex facilities;
- cost of funding cash that a prudently managed company will hold; and
- cost of pre-funding debt maturities.

It is imperative that these items are included when making an assessment of the 'all in' cost of debt.

Q3: Do you agree with our proposal to index price controls to CPIH (subject to its redesignation as a national statistic before we publish our final methodology)?

Neither agree nor disagree – N/A

To have legitimacy, the index used must be a recognised National Statistic that is actively used by Government and ONS. In our view, therefore, it would be beneficial if the options for indexation are kept open until the Government and associated bodies have committed to using a specific index. We note that some vulnerable customer incomes (pensions & benefits) have links to CPI rather than to CPIH. In addition, as there is no market for CPIH debt, investors would not be able to hedge the regulatory measure of inflation if CPIH were adopted. For these reasons our current preference would be for CPI.

Q4 Do you agree with our approach to setting tax allowances at PR19, including the proposed true up mechanism?

Agree

We broadly agree with the proposed approach to setting tax allowances at PR19. In particular, we agree with the principles relating to the treatment of interest, capital allowances and group relief as they represent a clear, standard approach for companies to follow.

We would offer the following comments on specific items within the suggested approach:

- Capital allowances – no mention is made of the status of brought forward pool balances; that is, are the balances subject to any significant potential amendment in order to be agreed with HMRC? It might be useful for companies to briefly state whether there is any uncertainty reflected in the starting position.

- Group relief – it is proposed that any group relief not paid for will be recovered as part of a tax true up mechanism. This would be acceptable where actual tax charges do not exceed the tax allowance. However, if a company's actual tax charge exceeds the tax allowance (not being due to tax or capital allowances rate changes) and was therefore unfunded, customers would not be disadvantaged where a company does not make a payment for group relief to the extent the 'free' or 'discounted' group relief covers the taxable profits giving rise to the excess charge.

The proposal for a true up mechanism is welcome as it ensures that customers pay no more than is implied by prevailing corporation tax rates. However, we do have a slight concern that the suggested timing of the true up (at the end of the price control period) could lead to counter-intuitive outcomes. We would therefore suggest the introduction of a true up within the price review period.

Depending on the political persuasion of the UK government, tax rates could rise during one review period (and therefore require the extra tax cost to be met by customers under the next true up) while rate reductions could be anticipated in the following review period (which customers might expect to lead to price decreases). A possible solution to this would be to adjust prices as contemporaneously as possible with tax rate changes, say in the year after new rates are enacted, at a suitable time to allow capture for tariff setting purposes. In cases where companies could be facing higher tax costs, this would also allow better matching from a revenue perspective.

Q4a: Should the true up mechanism be limited to change in corporate tax rates and capital tax allowances or should we extend that true-up mechanism so we can also make adjustments for other changes in tax legislation or accounting regulations which have a material impact on the amount of tax companies are liable to pay?

Neither agree nor disagree – N/A

We agree that the true up mechanism should include changes in corporation tax rates and capital allowances, and should be extended for other significant changes in tax legislation that would have a material impact on tax liabilities. We support a true up mechanism that is simple, transparent and effective. We strongly support the retention of incentives for companies to legally minimises tax through efficient operations as this benefits customers in the same way as minimising any other cost. We would strongly disagree with any dilution of this incentive as not being in the best interests of customers.
For a true up to be as effective as possible, we believe the mechanism should recognise the impact of other items that have a material impact on a company's tax charge. This could include significant amounts arising from future changes to UK tax legislation or accounting standards.

For example, in July 2017, the Office of Tax Simplification issued a report that included a recommendation for further work to be undertaken on the tax treatment of capital expenditure. This would explore the issues involved in replacing the present capital allowances system with an accounts depreciation approach. If such a change was made, companies' tax charges could be materially affected by the transition from the 'old' to

the 'new' regime and by the annual amount allowed as a deduction in computing taxable profits compared to previous capital allowances.

We agree that any true up mechanism should not place an unnecessary burden on either Ofwat or companies and should therefore be restricted to material items. In this regard, we do not believe that a more comprehensive true up (along the lines of the approach used by Ofgem) should place too onerous a burden on companies and would therefore support the inclusion of additional items in the true up. However, we would support the use of a cut-off measure to ensure the true up only captures material adjustments. The level that is proposed (ie where the cumulative impact on the tax allowance is in excess of 1% of allowed revenue) appears reasonable. Therefore, we support Option 3 in Appendix 13, Section 6.7, with an appropriate materiality threshold.

However, we would reiterate the point made above that a true up that does not take effect until the start of the next AMP is not effective and risks being lost in the next price setting cycle. We would also stress the importance of retaining appropriate incentives for companies to manage tax costs efficiently.

Q5: Do you agree with the set of scenarios for RoRE analysis we have prescribed, the guidance we propose and to use our financial model to provide the suite of prescribed scenarios?

Agree

We welcome the smaller list of scenarios than in PR14 and the focus on the areas where company performance impacts on RoRE: changes in revenue, totex, ODIs, C-MeX, D-MeX, retail costs and the cost of new debt.

We believe that these are the key areas for regulatory review, and that wider economic scenarios would be less valuable for stakeholders. This is because wider scenarios are not in the control of companies and so are more difficult to forecast; it is also more difficult to assess their impacts.

Aligning risk and return: financeability

Q1: Do you agree with our overall approach to assessing financeability?

Agree

We believe that financeability for the notional company should be considered as a cross check when setting the cost of capital. Should financeability issues arise for the industry as a whole that would suggest that the level of the cost of capital should be revisited.

We welcome the publication of the financial model and confirm that we intend to use the model and its functionality in our financeability assessment.

We also welcome the references made to the 'natural rate' for PAYG and RCV run off rates. These are very useful reference points for discussion with stakeholders and we intend to make reference to this in our plan and in our stakeholder engagement.

Q2: Do you agree the calculation of the metrics (as set out in Section 11.5 in the Financeability chapter) that we are proposing to use in our assessment?

Agree

We agree with the metrics set out in Section 11.5.

Accounting for past delivery

Q1: Do you agree with our proposed approach for dealing with PR14 reconciliations and SIM? If not, please explain your alternative approach and why this would be in customers' interests.

Agree

We understand why the SIM mechanism will not apply in 2019-20. We also suggest that it is dropped as a reputational incentive and is replaced with the C-MeX pilot for 2019-20 as it would be confusing to be running two different customer measures in tandem. Companies would still be free to continue with an internal SIM measure for 2019-20 if they wish.

The matching of the incentives to the specific controls in Table 12.2 all seem reasonable. We also welcome the retention of the option to spread adjustments over the period in a net present value neutral way.

We welcome the earlier delivery of PR14 reconciliation models in July 2018 as we agree this should help make an early start to the initial assessment.

In the totex performance model, we have a particular concern over the treatment of a large non-cash pension curtailment accounting adjustment that we reported in 2015-16. The PR14 rulebook for totex performance does not appear to include a mechanism for removing this sort of significant, atypical, non-cash amount. This means that by default it could be treated as efficiency, which would not appropriately represent the nature of the accounting credit. We will explain how we believe this should be treated in our submission of the PR14 reconciliation model next year.

Q2: Do you agree with our proposed approach for reflecting how well the company is delivering for customers over the 2015-20 period in the initial assessment of business plans? If not, please explain your alternative approach and why this would be in customers' interests.

Strongly agree

We strongly support the inclusion of company performance over 2015-20 in the Initial Assessment. We agree that delivery of commitments over 2015-20 should provide more confidence in the PR19 plans.

Securing confidence and assurance

Q1: Are the business plan and data requirements clear and sufficiently specified?

Neither agree nor disagree – N/A

The draft methodology appears to be clear and sufficiently specified in the requirements with respect to business plans and data. There may be questions of clarification as we start to complete the tables and work through the detail.

One initial observation is that Tables WS18 and WWS18: Explaining the 2019 Final Determination should only be used in industry aggregate and cannot be used for comparisons between companies, as, for example, Water Customer Service (Block A, WW18) cannot be measured through just three metrics: risk of drought, residential customers metered and number of complaints about drinking water.

Q1a: Are there any areas we need to look at again?

Neither agree nor disagree – N/A

Other than as detail is developed there are no areas that we think Ofwat should look at again.

Q1b: Is there any data missing, or included but not required?

Neither agree nor disagree – N/A

We have not identified any data that is missing or included but not required.

Q2: Do you agree that our approach to assessing assurance can provide us and stakeholders with confidence in the companies' business plans?

Agree

We agree with the proposed approach to assessing assurance. Ofwat has clearly set out its expectations for assurance and governance, Board assurance, meeting statutory obligations, the company's record in producing high-quality data and the quality of data as part of the submission. We agree that the company monitoring framework should be used in assessing companies' records in producing high-quality data. As an embedded and established process, using the company monitoring framework provides confidence in the assurance approach.

A further point of clarity would be on the timing of the 2018 assurance assessment. We suggest that this could be notified at the same time as the initial assessment of business plans (IABP) in January 2019. Publishing as planned in November 2018 now appears to be out of step with key dates in the price review.

It is efficient and provides consistency for Ofwat to require companies to use a common set of data tables. We also look forward to the online data capture system, which we think will be an improvement on previous Excel based templates.

Notification of the timetable for early data submissions is helpful. We agree that having this information early enables Ofwat to meet the January 2019 publication of the IABP.

Independent reports from the Customer Challenge Groups (CCGs) are an important source of assurance for customers. We agree that the format and detail of the CCGs' reports is for them to decide. We agree that the CCGs' views should be used towards evidence on how business plans have addressed affordability and vulnerability.

Our CCGs have submitted their own response to the draft methodology consultation. We support the submission and in particular the four suggestions, outlined in the response, that seek to enhance the transparency of the CCG role and to support CCGs.

The initial assessment of business plans: securing high quality, ambition and innovation

Q1. Do you agree with our proposed approach to the initial assessment of business plans?

Agree

We broadly agree with the proposed approach to the initial assessment of business plans. We can see that a structured approach and using pro-forma will signpost companies' responses and help Ofwat to navigate business plans efficiently. Breaking down the assessment into manageable portions should lead to more efficient and consistent assessments.

We agree that business plans should be of a manageable size and not seek to overwhelm with detailed content. The stipulation that plans should be no more than 300 pages implies that more traditional documents are envisaged. We would prefer to have some freedom to consider innovative and more creative presentations for our business plans using digital technology. This would allow more scope for co-creation with customers and presentation of material in accessible and customer friendly formats.

Q1a. In terms of the nine test areas?

Agree

The nine test areas set out a very challenging set of questions that together form the basis for comprehensive and evidence-based assessments. The value of the test areas will be revealed in the way they are applied. For example innovation should be about a company's culture, its approach to risk, evidence of it being a learning organisation, i.e. much more than the application of new processes and techniques.

Q1b. In terms of the business plan characteristics we want to see? (high quality, ambition and innovation)

Agree

Expectations are clearly set out in terms of high quality, ambition and innovation.

Q1c. In terms of the business plan categories we propose to assign companies' plans to? (significant scrutiny, slow-track, fast-track, exceptional)

Agree

The proposed business plan categories are clear and in essence look very similar to those that were applied at PR14. Enhanced becomes exceptional and standard is split into fast-track and slow-track, much as occurred at PR14. We agree that slow-track and significant scrutiny plans should receive interventions and adjustments in order to protect customers.

Q1d. In terms of the financial, procedural and reputational incentives we propose to put in place?

Strongly disagree

Although we strongly agree with the intention and broad framework of putting in place financial, procedural and reputational incentives, we consider that the financial value of the incentives is inadequate and that this needs to be addressed if the proposals are to achieve the desired outcomes.

Financial incentives need to be of sufficient value for companies to take the risks necessary to significantly stretch performance. This could include risking additional investment or introducing new ways of working. Reflecting the way markets operate, efficient and high performing companies should be much better rewarded than the rest.

The only guaranteed reward is the uplift on the cost of equity for an exceptional business plan. Building on the proposal for financial rewards we believe that this will be much more effective if it is significantly higher than the proposal of 0.2% on the cost of equity, equating to just 0.08% on the WACC.

At PR14 the reward for enhanced was 0.1% on the WACC. At PR14 the potential reward was unknown until after plans had been submitted. This had the effect that the incentive to achieve enhanced acted more like a reputational reward. We are surprised that the proposed reward for exceptional is less than the PR14 reward for enhanced. We believe it would be consistent with Ofwat's desire to create a more highly incentivised framework for the reward for exceptional to be significantly greater.

The intention to restrict rewards to just one or two companies that achieve the exceptional standard may also act as a disincentive for companies to submit stretching plans. We therefore believe that some financial reward should also apply to fast-track. We believe that to create meaningful incentives the rewards should be at least 0.25% on the WACC for exceptional and 0.1% for fast-track. We believe customers would benefit from these more powerful incentives through the generation of more stretching and ambitious plans.

In addition to potential guaranteed rewards, non-guaranteed rewards are available in the form of outcome delivery incentives. We agree that such rewards should only apply for upper quartile performance. They should continue to apply where a company maintains its performance, while remaining upper quartile. We support enhanced rewards for significant outperformance and enhanced penalties for very poor performance. We also agree that there should be no deadbands between penalties and rewards.

In line with the principle of symmetric rewards and penalties, this could be addressed by increased cost sharing rates for companies with exceptional plans.

We also strongly disagree with the proposal that an average company with average performance should expect to incur penalties on its ODI package. It is typically the case that every company will have some examples of average and below average performance and it seems likely that – under the current proposals – the majority of companies would be in net penalty and would therefore be earning below Ofwat's cost of capital.

In terms of procedural rewards, we agree that excellent business plans, defined as fast-track and exceptional, should benefit from such rewards. Receiving an early draft determination is an appropriate procedural reward. For customers this is an important source of trust and confidence.

Reputational rewards are also important to companies and we agree with the benefits of communication opportunities for a plan classed as exceptional.

In summary although we agree with the broad framework that is being proposed, we consider that to have the intended effects there would need to be much larger and more widespread financial rewards in place. This would see the financial, procedural and reputational incentives amended as follows:

Category	Reputational incentives	Procedural incentives	Financial incentives	
		Draft determination	Financial reward	Cost sharing rates
Exceptional	Published performance relative to peers + communication opportunities	Early (March/April 2019)	Allowance calculated as at least 0.25% on the WACC	Increased
Fast-track	Published performance relative to peers	Early (March/April 2019)	Allowance calculated as at least 0.1% on the WACC	Standard
Slow-track	Published performance relative to peers	July 2019	None	Standard
Significant scrutiny	Published performance relative to peers	July 2019	None. Potential cap on ODI rewards	Reduced

Q2. Do you agree with our approach to assessing a company's ability to deliver results for customers and the environment from innovation?

Agree

We agree with the expectations regarding innovation. The best plans will be ambitious and will only be delivered through innovative ways of working.

Consultation questions relating to Appendix 14 on the initial assessment of business plans

Q1. Do you agree with the key questions under each of the test areas?

Agree

We agree with the questions under each of the test areas.

Q2. Do you agree with what we will look for in terms of high quality, ambition and innovation under each of the test areas?

Agree

We agree with what is being looked for in terms of high quality, ambition and innovation under each of the test areas.

Q3. Do you agree with our high-level approach for scoring business plans into the four categories (significant scrutiny, slow-track, fast-track, exceptional)?

Agree

We agree with the high-level approach for scoring business plans into the four categories (significant scrutiny, slow-track, fast-track, exceptional).

Q4. Do you agree with our proposed schedule of the initial assessment of business plans?

Agree

We agree with the proposed timeline for the initial assessment of business plans.