

# THE WATER REPORT EXPERT FORUM

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We are actively seeking new members, so if you are working at a reasonably senior level in the sector, within a company or at another stakeholder organisation, please email [karma@thewaterreport.co.uk](mailto:karma@thewaterreport.co.uk) to join. Thank you very much to our existing members.



## CAUTIOUS WELCOME

How did The Water Report Expert Forum greet Ofwat's initial thinking on PR24?

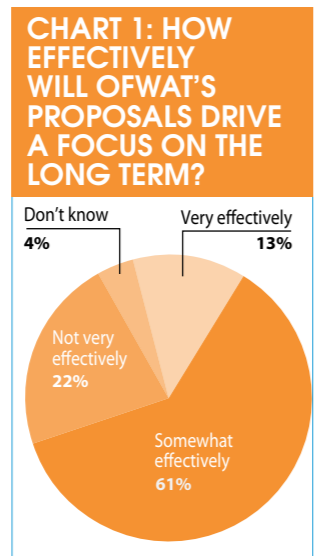
In late May, Ofwat published its high level thinking on the framework for PR24 and future price reviews. We asked members of The Water Report Expert Forum for their initial views on the key proposals. While sentiment is inevitably mixed, the overriding picture is one of welcome for many of the strands of thinking, caveated by caution on how the detail will develop, and supplemented by ideas on how the proposals could be improved further.

### Sense of longing

Ofwat stated clearly that it wants future price controls to focus on the long term. To achieve this, it proposed ideas including: requiring companies to position their five year business plans in the context of long term strategies; providing an early view on elements including allowed return, common Performance Commitments (PCs) and associated Outcome Delivery Incentives (ODIs); and being clearer on its expectations of future price reviews.

As chart 1 shows, the regulator had some success in convincing The Water Report Expert Forum that its proposals would drive a focus on the long term. 74% said the regulator's plans would drive a focus on the long term very (13%) or somewhat (61%) effectively. Only 22% thought the plans would not very effectively drive long term thinking.

Some participants expressed outright support. Most said the effectiveness would depend on various factors. Chief among these were incentives



– “Investors and companies respond to incentives, not rhetoric;” “It will probably hinge on whether Ofwat can develop a set of incentives that promote both long term decision making and delivering greater environmental and social value. If it manages to do so, there is some great potential. Otherwise, we’re probably back to finger pointing on who is to blame for short termism.” Linking up effectively with other strands of policy was another key dependency identified: “If a credible mechanism is put in place to give good long-term certainty, linking clearly with obligations to all regulators and aligning to WRMPs and DWMPs, then this could be a big step towards a longer-term outlook. If, however, it simply results in more work to produce a PR24+ plan, with little no guarantee that longer term commitments will be honoured (by companies and/or Ofwat), then it will merely add to the effort associated with PR24 without adding value.”

Many simply pointed out that we need more detail to make a valid assessment. For instance: “It’s impossible to answer with confidence at this part in the process. The consultation document says all the right things about outcome-based regulation and setting a long-term direction but the devil will be in the detail. The mechanism is it cur-

rently proposing is not transformational.”

Of those unconvinced that PR24 thinking will result in a focus on the long term, a good number cited history and experience as the main reason. An example: “At every price review since PR04, Ofwat has stated its ambition to undertake the five yearly price review in the context of a longer term. But ultimately has reverted to a focus on the five years only. I would like to think this time will be different but I have reservations.”

Others reasoned that some of the core tenets of the thinking did not align with driving focus on the long term. Some comments here were:

“Ofwat seem to be focusing on the core regulation of outcomes that can be compared, and national obligations. It seems more likely than not this will result in companies focusing on Ofwat’s regulation in the short term, rather than long term outcomes, customer and stakeholder needs.”

“While the use of long term PCs targets is somewhat useful, the cost allowance is still heavily geared towards minimising costs in the short term. There is a huge risk to companies of proposing an increase in capital maintenance costs, and a strict evidence bar for any that do. As such, the sector will continue to focus on proposing the minimum level of capital maintenance expen-

diture possible, which may not be the best long term solution.”

### Even longer?

We also asked respondents what else they would like to see to secure a focus on the long term. Among the suggestions were:

“Explicit instructions from Defra and Welsh Government to Ofwat.”

“A process that encouraged more engagement in local plans for net zero and ecological emergency, and local infrastructure.”

Longer planning cycles and rolling business plans.

Asset focus – “Incentives for value and for asset health and resilience which cover multi-AMPs and which apply to companies over that time frame. A recognition that we originally called them AMPs for a reason - they are Asset Management Plan periods - it’s not just about price controls;” “More of an open debate around what the ideal level of asset replacement should be.”

“Although the price review discusses climate change, it would be good to see stronger language that this is a key requirement.”

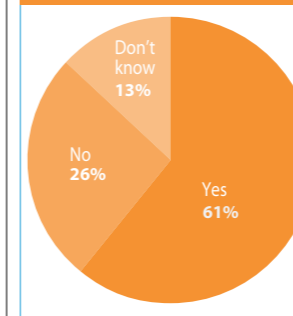
“Regulators to focus on outcomes for customers and the environment rather than on meaningless and misleading in-period inputs and outputs, such as leakage and PCC. Outcomes should be defined for the long term and incentives aligned to their cumulative delivery.”

### Outcomes are in

There was also majority support (61%) for Ofwat’s idea of focusing on a smaller number of common outcomes than at PR19, as shown in chart 2.

Many argued simply that this was a sensible approach and would deliver more benefit. Comments here included: “Focus should be on the things which really matter to customers;” “Ofwat can define the issues and outcomes to provide much needed focus and consistency;” “It is less confusing - let’s look at where 80% of the impact can be achieved through 20% of the outcomes;” “Currently, there are two many PCs for management to deal with;” and “The proliferation of bespoke PCs was not helpful either for planning and decision making, for communication with stakeholders or for focused incentives.”

**CHART 2: DO YOU SUPPORT OFWAT'S IDEA OF FOCUSING ON A SMALLER NUMBER OF COMMON OUTCOMES THAN AT PR19?**



Some of those who disagreed with the proposal to focus on a smaller number of common outcomes did so strongly. One argued the opposite was desirable: “In recognising the breadth of the industry’s stakeholders, you could argue that we actually require more.” Others were concerned local priorities would be neglected. For instance: “Outcomes that relate to customers and the environment should be based on community and catchment values and objectives. The localities and catchments are diverse and so should be the outcomes.”

For others, there were advantages and disadvantages from the approach. One commented: “The price review framework is just way too heavy. But we don’t want to lose crucial focus on areas like water poverty and water efficiency.”

We asked a follow up question about views on companies pursuing additional outcomes outside the price review, for instance through KPIs. The Forum was polarised. Most were very comfortable with the idea, some very supportive, commenting among other things that this would allow flexibility, innovation, add value and enable companies to deliver local/regional priorities.

At the other end of the spectrum were those who gave the idea little credence. For instance: “Always been window dressing. Rarely seen KPIs drive outstanding outcomes

for customers or the environment in the water sector.” One raised the issue of complexity: “It adds confusion. How should they deal with circumstances where meeting the KPI undermines the price control target and vice versa?”

A good few took a very practical line on this, simply questioning how additional outcomes would be paid for. This was summarised by the member who responded: “Fine, but where is the funding going to come from?” Another observed: “Companies are already doing this through vehicles such as the Public Interest Commitments from Water UK which has really driven a focus on important areas such as the Net Zero Routemap. The problem with this additional focus means it is unfunded. So that presents an issue regards the ambition/investment gap.”

### Up to the benchmark?

In its PR24 curtain-raiser, Ofwat said it plans to improve its cost benchmarking and extend its use. We asked for views and what the Forum’s improvement priorities would be.

Some were wholeheartedly in favour of Ofwat’s position. One said: “I strongly support. Cost benchmarking is arguably (alongside the WACC) the key contribution that Ofwat is uniquely placed to undertake.” Others commented: “With some notable regional exceptions (Thames Water/London

based operations) costs are broadly similar across England and Wales;” and “It is really important to call out where companies are outliers.”

Some were broadly comfortable, as long as certain measures are put in place, such as the wide sharing of benchmarking data for external validation, and ensuring the methodology is well understood.

Most dwelt on the improvement aspect of the PR24 paper though, arguing that there is clear need to improve the benchmarking techniques used. Among the areas identified as weak were retail cost benchmarking, enhancement models, water base models, capital maintenance, the need for more data points in wastewater models, bioresources and water resources.

Among the wider improvement opportunities cited were: “Having cost benchmarking that takes account of company-specific factors, e.g. historic differences in investment prioritisation, population change, geography etc. makes sense, however all of these factors increase complexity and the potential for benchmarks to be contested. If a company is adequately able to justify their costs, then benchmarking should be used as a supporting tool to inform debate on the potential for efficiency, rather than as a blunt instrument to reduce company allowances.”

“The approach needs to be developed collaboratively with companies. The current models need to ensure an appropriate approach to taking into account quality of service and the long term need to maintain asset health.”

“It will be all about what they use to benchmark. If it squeezes costs too much, that won't lead to the right outcomes for customers and the environment and society. If it looks more widely at the brilliant multiple benefits companies x

and y have delivered with higher costs that WILL be helpful and effective. Looking at a wide range of benefits to society and the environment is crucial in this, otherwise it will backfire.”

Some took a dimmer view – for instance: “Improve - yes. It could not be worse than the existing approach, which makes many assumptions that are untested. Extend - to what? Only if it can be improved. Given the lack of comparability of the companies and their customers, improvement is unlikely. Simplification would be essential.”

**Financeability frets**

Ofwat's suggestions to update the risk & return framework included indexing allowed return on equity, moving to full CPIH indexation, and exploring its approach to financeability taking account of how it defines the notional capital structure.

Some respondents welcomed all of the above, a number commenting that full CPI indexation is widely expected anyway (some noting though a need for appropriate transitional arrangements), and that indexing equity returns aligns with Ofgem's position and reduces risk of under or over forecasting at the start of PR24 (again though, some said this wasn't worth the complexity it introduces). Others were less welcoming of the changes. One asked: “What are these changes intended to achieve? They will weaken incentives - on the whole a bad thing.”

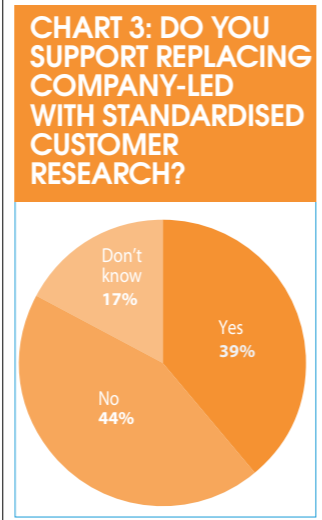
Financeability seemed to be the greatest cause for concern. Some argued financeability should not be artificially maintained by adjusting PAYG as at PR19; others called on Ofwat to accept financeability is determined by credit rating agency metrics rather than its own. One member called for more explicit consideration of financeability at targeted levels of gearing. Another said: “The financeability

aspect needs to be handled with care as to not cause another wave of rating downgrades. Any expectation of de-gearing should allow companies time to do so organically by adjusting their dividend policies.”

Within the financeability area, there was particular concern about Ofwat's comments on notional capital structure. “I think linking financeability to the notional capital structure will be problematic,” one commented. Another argued more forcefully: “The bigger issue is playing around with the notional structure to deliver a desired outcome in terms of financial ratios. Ultimately the notional structure should be broadly stable and attainable otherwise it's simply a goalseek function to avoid providing companies with appropriate cash flows.” Yet another observed: “The view that financeability issues should be fixed by changes in the notional structure are not addressing the causes of any issues, and run counter to the CMA's determinations.”

**Research wrangle**

As chart 3 shows, the idea of replacing company-led customer research with standardised or national customer research at PR24 really divided the Forum, with 39% in agreement versus 44% in disagreement.



Among the comments from those who agreed with Ofwat's proposition were: “Agreeing a set of values to underpin both incentives and decision making frameworks is going to be key to enabling incentives to deliver more environmental and social value;” and “There is a strong argument for consistency. See for example water efficiency and social tariffs which should actually be consistent across the industry rather than a postcode lottery.”

Some were supportive, but with the caveat that the standardised research must be done well. Some examples:

“As long as a standard/national research effort splits out individual company results to highlight regional differences, and as long as the questions are set in a mutually agreed forum (i.e. not designed to lead the respondent to a certain conclusion favoured by one party), this should improve comparability and reduce overheads. Additionally, that questions are linked to the critical outputs and therefore the focus of the water companies' business plans.”

“Yes a standard approach would be helpful but there needs to be some flexibility to reflect different views from customers of different companies. Customers of neighbouring water companies may have different views and priorities because of their experiences and perceptions of their incumbent. We should not be aiming to get a standard response from customers.”

“A standardised approach would improve comparability of results and may save costs for companies. It is important, however, that we don't end up in a situation where companies just do whatever other research they want to over and above anything Ofwat mandates and then there is a protracted debate about whose results are right. The 'standardised' approach needs to include multi-

ple approaches to reflect a consensus across the industry; the debate can then focus on how to interpret the results rather than commissioning lots of additional competing research.”

Meanwhile, those who did not support standardised research made among the following observations: “Dilutes the company-customer relationship;” “Diversity of customers and circumstances suggest not. How will the 'national standard' be determined? Innovation and more sophisticated approaches are required not the lowest common denominator;” and “It is a retrograde step. As with much of the PR24 high level design document, it feels more like PR04 and PR09 being reinvented rather than progress from PR14/PR19 frameworks. Even if it could add value, it seems unlikely it will deliver in time.”

A few took a more balanced line, with comments including: “I think national lead customer research is positive - but the national research should not entirely 'replace' local (company) research. Whilst a national approach could include some local assessment it might well be necessary for the company to test and refine this if local issues/preferences etc.”

“There are generic elements that have been shared effectively by CCW, for example on the need for a single social tariff, so social outcomes around vulnerability and affordability are perhaps better suited to this high-level. Environmental outcomes and needs need to be considered more on a regional basis. WRSE have started good thinking around a Regional Resilience plan using some customer research.”

**Not so challenging**

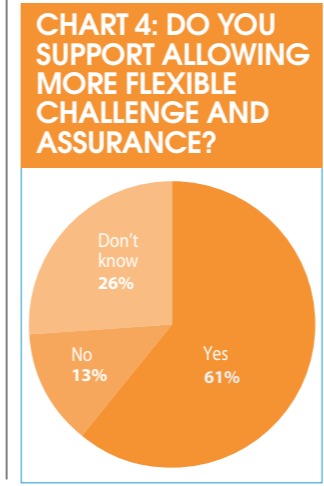
Ofwat won considerably more support for the idea of allowing more flexible challenge and assurance arrangements

at PR24 rather than mandated Customer Challenge Groups (CCGs). As chart 4 illustrates, only 13% disagreed with the regulator's stance, compared to 61% in agreement.

Among those who disagreed were those who rated the past contribution of CCGs, such as: “CCGs are an important and valuable part of the PR process. Over the years there have been significant wins for customers from their use.” And those who fear the dilution of the customer voice in regulation: “Not engaging with local CCGs means Ofwat will not be engaging with local plan issues. The assurance arrangements will not reduce, but more that companies will have to follow Ofwat's view of what topics should be engaged on and how they should be discussed. This means the industry will inevitably increase focus on what Ofwat want, rather than customers (see David Gray review 2011 why this is a bad idea).”

However these views were outweighed by those which saw benefit in Ofwat's proposed approach. Among positive reasons cited were flexibility, innovation, broader challenge and lower cost.

Others pointed to the under-performance of CCGs at previous price reviews as their reason for supporting a change. For example; “CCG are not Customer Challenge Groups they are



stakeholders Groups...They are inconsistent in their approach and customer views should be sort in multiple ways.”

Some pointed out that there may not be anything inherently wrong with the concept of CCGs, but rather that they way the groups have been managed and treated by Ofwat has been problematic and led to under-performance. “Whilst CCGs have not all worked well and have sometimes departed from their brief, I'm not sure a loss of continuity and consistency of approach is helpful for anyone. It would be better to address the issues with CCGs.” Another: “I think the role of CCG in PR19 and its perceived lack of influence in the end means an alternative is required. But used properly the principle can provide informed scrutiny.”

**Unfazed**

In terms of process and procedure, Ofwat's PR24 paper proposed a number of options for the procedural stages of the next price review, variously combining Initial Assessment of Plans, Draft Determinations and Final Determinations. Virtually all respondents favoured some kind of streamlining of the PR19 arrangements, most commonly to merge the IAP with the DD stage, leaving just two – DD and FD – main phases. The main reasons cited were efficiency, simplicity and clarity. One made the observation that: “Ofwat should be clear about whose benefit the changes are for. Is it to allow them greater time to scrutinise plans? Is it to allow companies as long as possible to develop plans? Is there to be more sharing of information about the process throughout?”

A couple felt one size wouldn't fit all: “If you've got a history of delivering for customers, streamline it. If you don't, why would you? There's potential there but it's not right

for every company;” and “Removing the IAP in its entirety would create a lot of risk in the process. This might be ok for fast tracked companies.”

As chart 5 shows, in the round just under half (44%) of respondents said Ofwat's PR24 proposals strike the right balance between simplicity and sophistication, at this early stage at least. One remarked: “Whilst I would have liked them to go further they are probably about right - an evolution is probably a prudent approach.” Another noted: “The recognition of the need for streamlining / reducing bureaucracy seems positive.”

However, while only 4% felt the arrangements mooted looked too simple, a third (35%) of Forum respondents felt they looked too complex. One advocated: “Price reviews have become far too complicated. It is time to strip it right back.” Another observed: “Apart from a slight reduction in PCs, there has been no meaningful simplification from PR19, which were the most complex price controls ever set.”

The final word goes to the respondent who made a pertinent comment reminding us all to look beyond the bubble: “Ironically, too complicated for me to spend enough time digesting everything, as a small not4profit with huge campaigning workload!”

