December 2022

Creating tomorrow, together

Our final methodology for PR24

Ofwat

About this document

This document sets out our final methodology for the 2024 price review (PR24). It describes our expectations of companies and approach to setting controls for the period from 2025 to 2030 for water and wastewater monopoly service providers in England and Wales.

Transforming the water sector

Water is central to our daily life. How the water sector performs now and into the future matters for all of us and our environment.

The sector is facing significant challenges and expectations have risen – customers, regulators and Governments are clear that change is needed: greater resilience to drought, significantly better outcomes for the environment and more responsive services for customers.

People question why hosepipe bans are needed when leakage is high. And they are concerned at the overuse of storm overflows – there are new standards that the sector needs to meet. Some of the challenges relate to our changing world. Climate change is not new, but the need for sustained action is clearer than ever.

Improving performance

The sector faces challenges because of how it performs. All companies have a number of obligations that are non-negotiable; they must deliver on them. If companies fail to deliver, we step in.

Ofwat's recent enforcement actions against Thames Water and Southern Water resulted in £257 million of financial penalties and rebates to customers, and significant changes in how they deliver for customers and the environment in the future. We are currently investigating compliance with various legal obligations by all wastewater companies in England and Wales, including in relation to the operation of their wastewater treatment works. We will not hesitate to act if we find companies have breached their obligations.

Customer service needs to improve as too often companies fail to get the basics right. Our research, jointly with CCW, into customers' experience of company responses to sewer flooding in their homes, highlighted the improvements that are needed. Even the best in the water sector fall short of service in other sectors and there is no excuse for water customers to get second best.

The sector also needs to act now – in advance of PR24 – where it is not doing enough. Significant improvements are still needed to drive down water demand, minimise supply interruptions and reduce pollution incidents. Companies are funded to deliver good quality services, and they need to improve areas of poor performance. In this context, it is disappointing that companies have spent only 68% of their enhancement cost allowances for the 2020 to 2022 period. Companies should be using this funding to deliver improvements quickly.

Rebuilding public trust

Companies need to recognise that the public's trust in them has been shaken as investors and executive teams appear to be rewarded despite companies failing customers and the environment.

Ofwat has asked companies to ensure that dividends and performance-related executive pay reflect how well they are performing for their customers and the environment. However, companies still have a long way to go to on both issues. We are consulting on a licence change to strengthen company accountability on dividends and taking action on executive pay.

Companies can also rebuild trust by ensuring that they have the financial resilience to cope with disruption or turn around poor performance without further costs falling on their customers. We have consulted on a licence change to ensure all companies meet high standards of financial resilience.

Rapid progress needed

We share the public's concern about the need to see rapid progress on the operation of storm overflows. In response to Ofwat's challenge, several companies have made commitments to improve river water quality and substantially reduce storm overflows by 2025. Of course, all companies must meet their legal obligations and we expect them to at least match the most ambitious commitments made by the leading companies. We are also aware of the challenge of making long term improvements to river quality to meet the aspirations of customers and stakeholders and expect PR24 to take a big step forward to deliver on substantive improvements.

Stepping up further

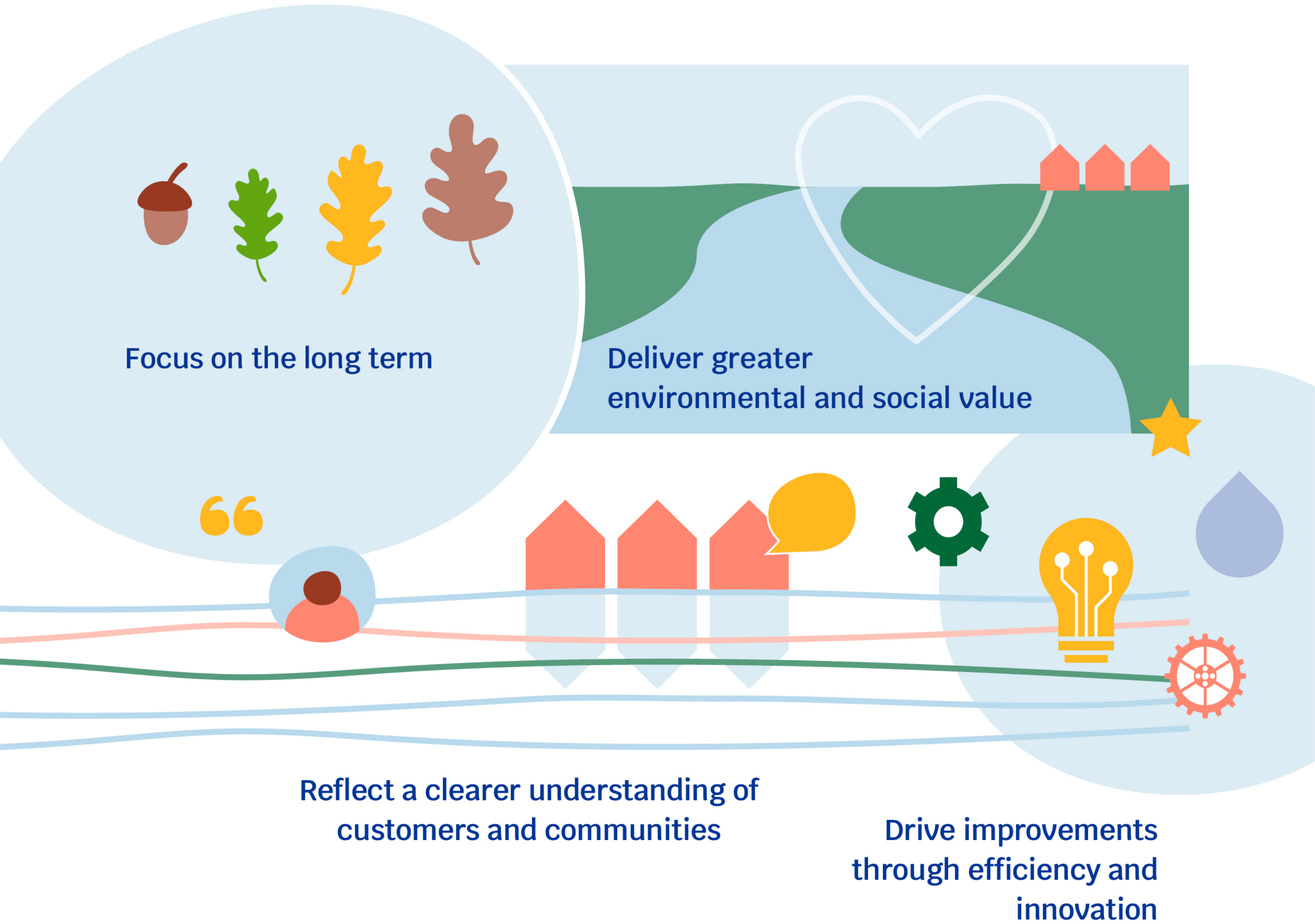
This publication principally focuses on how the water companies will operate between 2025 and 2030 and beyond. But it is clear that there is a lot that needs to be done before the next price review takes effect.

The sector needs to be in a stronger position so that it can innovate and step up further and deliver against new expectations at PR24. It must seize the opportunities to move forward and deliver the resilient services that everyone deserves and to reach higher to achieve more stretching levels of customer service and environmental stewardship.

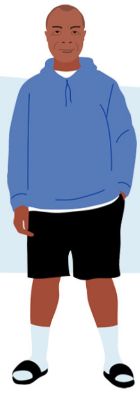
David Black
Chief Executive

PR24: building a better future

Our methodology for PR24 sets out how we will drive companies to deliver more for customers and the environment. The methodology reflects our four key ambitions for the review:



More for customers and the environment



Companies need to innovate constantly to achieve the best outcomes for customers, communities, and the environment at a cost that people can afford. PR24 will ensure that customers do not pay more than they need to, and reward only those companies that are ambitious and deliver great outcomes.

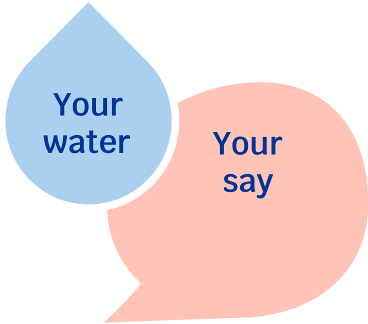
We will do this by setting stretching but achievable performance targets for the whole sector. And we will encourage companies to go further, with simple and powerful incentives to deliver better performance where it is in the interests of customers, communities and the environment.

PR24 will focus on the key outcomes that matter into the long term for customers and the environment. We will incentivise companies to deliver excellent customer service, protect and enhance the environment, and to maintain and improve the health of their assets.

We will build on the measures of customer experience introduced at PR19 to drive up standards for residential, business and developer services customers. There needs to be a step change in customer service levels and we will increase the financial incentives to drive this change.

We are introducing a broader range of environmental commitments including on the use of storm overflows, eliminating serious pollution incidents, improving biodiversity, improving bathing water quality and delivering reductions in greenhouse gas emissions. PR24 will incentivise companies to maintain and improve asset health, and we will drive a greater focus on asset stewardship for the long term alongside action in the price review.

Listening to customers



Companies' business plans need to reflect the expectations of customers and communities for the services and benefits the company will deliver, and the costs of those services. Our ambition is that residential and business customers', and the wider community's, voices are heard more directly and more effectively in PR24 than ever before.

We are ensuring that there is robust research to reveal customers' relative priorities and views on the outcomes that companies need to deliver. And we are requiring companies to hold two 'Your water, your say' meetings, which provide an opportunity for customers, and for community and wider stakeholders, to challenge companies on their plans directly in an open forum.

Driving ambition and innovation

We expect companies to propose stretching targets, and to be responsive to wider expectations. PR24 will reward ambitious plans, and there are opportunities for companies to lead the sector – our approach will reward companies that go much further and faster to meet customers' expectations on key outcomes.

Innovation will be key. On leakage, for example, companies will be rewarded if they can set and deliver aggressive reductions. We expect companies to embrace the opportunities to improve performance through smart technology and better use of data.

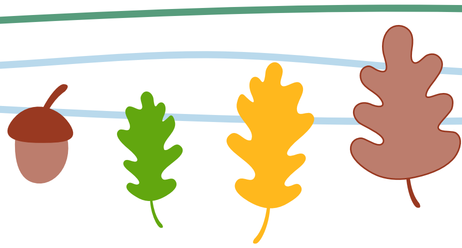
We have also set a net zero challenge that will ensure that the sector as a whole makes the most progress at least cost.

More generally, companies need to help their customers to use water more efficiently – average water consumption in England and Wales is currently 146 litres per day, compared with a target of 110 litres per day. PR24 will introduce a fund of up to £100 million to help stimulate a transformative, sustained and measurable reduction in water demand nationally, using a range of water efficiency approaches.

PR24 will continue to push companies to work innovatively to achieve more. We will incentivise companies to work in partnership with others where appropriate to deliver better outcomes for customers and the environment. We will continue to use development funding to drive more progress on the delivery of strategic water resource solutions.

In 2020 we launched our £200 million Innovation Fund to support initiatives which bring significant benefits for customers, communities and the environment. We look forward to seeing the successful innovations being rolled out by companies in the PR24 period. And we will extend our Innovation Fund to provide at least £300 million to support further sector-changing ideas and ways of working at PR24.

Long-term improvements



Delivering against higher expectations will require major new investments. This will create upward pressure on bills over and above the impact of inflation. It is vital that companies plan and deliver best value solutions.

Our approach in PR24 will mean that customers' money can be spent well to deliver what is needed over the long term. Funding will support efficient enhancement investment, both in the short and long term.

We are requiring companies to set their five-year business plan in the context of a 25-year long-term delivery strategy. Companies need to plan over the long-term and we expect them to use adaptive planning to identify what needs to be done in 2025 to 2030 and what decisions should be scheduled in future periods when there will be greater certainty. This will lead to a clearer focus on the long-term needs of customers and the environment and better decision-making on how those needs are met.

These delivery strategies will focus on the long-term improvements needed, in line with the priorities set for Ofwat by the UK and Welsh Governments. And the review will challenge companies to deliver efficiently across their plans. We will allow customers' money to fund only the efficient costs of providing services. Where significant new investments are identified, we will ensure that customers don't pay if companies fail to deliver.

Our approach enables companies to invest now in improvements that will benefit future generations. PR24 will steer companies more firmly to ensure that the costs of these improvements are shared fairly between current and future customers. Companies are also incentivised to propose voluntary sharing of benefits with their customers, and to identify innovative ways to support customers who struggle to pay their water bill.

The role of investors

Investors have a key role in providing the finance necessary for companies to deliver their activities – it allows new investment in PR24 to be recovered over the long term. The returns investors earn will depend on the performance of companies as well as reflect the risks they take and the level of investment. These returns are ultimately paid for through customers' bills – so ought to be no more than necessary to attract investment to the sector.

We have set out our methodology for determining the allowed return on capital. Two years ahead of final determination, we have provided an early view of the allowed return, which is 3.29% (in real, CPIH terms). This is above the allowed return set at PR19, reflecting changes in interest rates. Our early view figure illustrates the application of our methodology and provides a number for companies to use in their business plans. We will use our methodology to set the allowed return in draft and final determinations reflecting market data at the time. However, we may index a component of the allowed return on equity if the recent levels of market volatility persist.

Companies and investors will earn rewards for delivering more of what customers and the environment want and need, and where they can innovate to drive down their costs further. Where they fall short of customer expectations, then returns will be reduced. The potential for much greater investment will bring greater opportunities for those companies that can deliver and perform well.

Dividends which reflect performance

We expect companies to set out their proposed dividend policies for 2025 to 2030, ensuring that they take account of company performance in delivering obligations and commitments to customers, communities and the environment, and long-term financial resilience. We also expect companies' performance-related executive pay arrangements to reflect stretching delivery for customers and the environment and performance overall.

Using markets to deliver

We are using markets where that is most effective, reflecting the UK and Welsh Governments' strategic priorities. We are requiring companies to use the Direct Procurement for Customers approach for all discrete projects over £200 million as this approach can drive down costs while maintaining quality. And we are reducing the regulation for developer services in England to reflect growing competition, and introducing pro-market reforms to the bioresources market in order to drive better outcomes for customers and the environment.

Contents

1. Introduction

This document sets out our final methodology for the 2024 price review (PR24). It describes our expectations of companies and approach to setting controls for the period from 2025 to 2030 for water and wastewater monopoly service providers in England and Wales.

1.1 Background

This final methodology follows on from:

- a draft methodology published on 7 July 2022[1];
- various workshops, webinars, briefings and meetings with stakeholders including (but not limited to) government bodies, environmental NGOs, consumer organisations, companies, and investors; and
- over 70 written responses.

We thank stakeholders for their engagement on our draft methodology, which has influenced and directly contributed to the final methodology.

1.2 Supporting documents

In addition to this document, which contains a series of chapters listed in the table of contents, there are a number of supporting documents. They include:

- Appendices, which provide further detail and our reasoning for our proposals
    - Appendix 1 – Affordability
    - Appendix 2 – Water trading incentive
    - Appendix 3 – Developer services
    - Appendix 4 – Bioresources control
    - Appendix 5 – Direct procurement for customers
    - Appendix 6 – Your Water, Your Say
    - Appendix 7 – Performance commitments
    - Appendix 8 – Outcome delivery incentives
    - Appendix 9 – Setting expenditure allowances
    - Appendix 10 – Aligning risk and return
    - Appendix 11 – Allowed return on capital
    - Appendix 12 – Quality and ambition assessment
    - Appendix 13 – Data and modelling
    - Appendix 14 – Impact assessments

[1] Ofwat, 'Creating tomorrow, together: consulting on our methodology for PR24', July 2022.

- Delivering UK government priorities for the English water sector through our 2024 price review final methodology
- Delivering Welsh Government priorities for the Welsh water sector through our 2024 price review final methodology
- Data tables (plus submission table guidance files), financial model (plus Openbox format file and user guide), and model suite diagram.
- Guidance for water companies: testing customers' views of the acceptability and affordability of PR24 business plans
- Independent consultancy reports
    - Early view of water sector betas for PR24 (FTI Consulting, December 2022.)
    - Retail services efficiency review 2022 (PwC, December 2022.)
    - PR24 final methodology glossary

1.3 Next steps

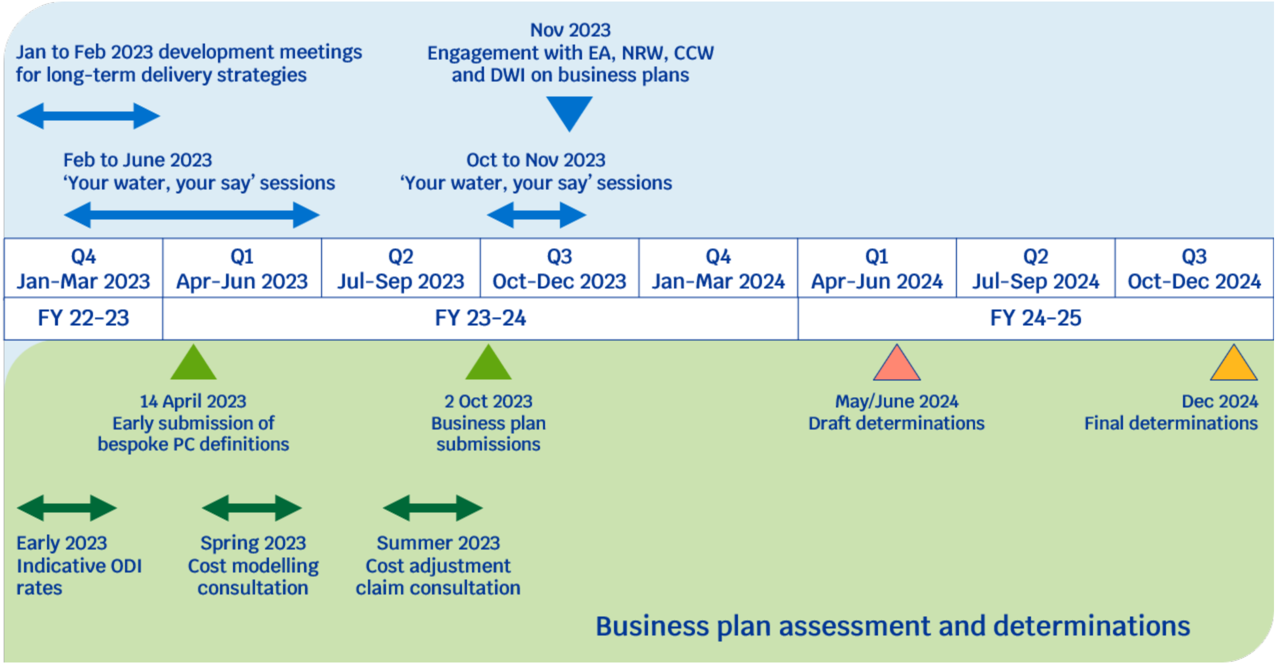
The next steps in the PR24 process after final methodology are illustrated in Figure 1.1 overleaf. We also provide detailed next steps in Appendix 12 – Quality and ambition incentive,[2] in addition to detailing opportunities companies have had to date to influence our price review policy and receive guidance and feedback before business plan submission.

We will run a queries process for specific questions about the methodology. Stakeholders should direct queries for clarification, corrections or further explanation in relation to the policies within our final methodology to PR24queries@ofwat.gov.uk. If a query is raised that we think is relevant to other stakeholders then we will publish the query and our response on our website.

There will be a separate process for queries around data tables and models. We will publish further details about this in early 2023.

[2] Table 4.1, pp. 17-19.

Figure 1.1: PR24 timeline



2. Overall framework

2.1 Introduction

In this chapter, we identify the key challenges facing the water sector and our ambitions for PR24. We explain how the price review will work within the wider Ofwat toolkit to help the sector meet the challenges we all face. Finally, we set out how we will evaluate PR24's impact on customers, communities and the environment.

The chapter covers:

- our statutory duties and the strategic policy statements (section 2.2);
- key challenges and our ambitions for PR24 (section 2.3);
- how we will use our regulatory toolkit, including the price review, to meet the challenges (section 2.4); and
- how we will evaluate the impact of PR24 (section 2.5).

2.2 Our statutory duties and the strategic policy statements

The PR24 final methodology reflects our statutory duties and the strategic policy statements (SPSs) from the UK government and Welsh Government that we must act in accordance with when we set price controls at PR24.

Our statutory duties require us to set price controls in the manner we consider is best calculated to:

- **further the consumer objective** to protect the interests of existing and future consumers, wherever appropriate by promoting effective competition;
- secure that water companies **properly carry out their functions**;
- secure that the companies **are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions**; and
- **further the resilience objective** to secure the long-term resilience of companies' systems and to secure that they take steps to enable them, in the long term, to meet the need for water supplies and wastewater services.[3]

We also have secondary duties that require us to regulate in the way we consider will best promote economy and efficiency as well as contribute to the achievement of sustainable development, amongst other duties. In addition, we must have regard to the principles of

[3] The general statutory duties for most of our work as an economic regulator that we summarise here are set out in section 2 of the Water Industry Act 1991. We also have general environmental and recreational duties set out in section 3 of that Act.

best regulatory practice, including that our regulatory activities should be transparent, accountable, proportionate, consistent and targeted.

We describe how the PR24 final methodology addresses the strategic priorities and objectives of the UK Government and Welsh government in the respective documents.[4]

The UK government's priorities for how we regulate English companies are to protect and enhance the environment, deliver a resilient water sector, serve and protect customers, and use markets to deliver for customers.[5] The UK government has also outlined strategic priorities for utilities sectors, which complements the UK government's SPS.[6]

The Welsh Government's priorities for how we regulate Welsh companies are the climate and nature emergencies, the environment, resilience, asset health, and customers and communities.[7] The Welsh Government has also set out strategic objectives for how it expects us to carry out our functions as applicable to Wales.

2.3 Key challenges and our ambitions for PR24

How the water sector performs matters for all of us and our environment. Despite improvements in some areas, the sector is not where it needs to be – and it must take urgent action to deliver better service for customers, communities and the environment. The challenges before us are clear:

- meeting **rising expectations** about what water companies need to deliver for their customers and communities;
- protecting and enhancing our **environment**, including sustainably managing our natural resources, and making rapid progress on the operation of storm overflows;
- adapting to **climate change** and meeting **net zero** emissions; and
- delivering **affordable bills**, in the context of increasing cost of living challenges.

Addressing these challenges will require companies to **transform performance** and **embrace new ways of working**. It will also require major new investments, at a time of significant affordability pressures and an increasing need to rebuild public trust in the sector. Taking these factors into account, we have identified four interrelated ambitions for PR24:

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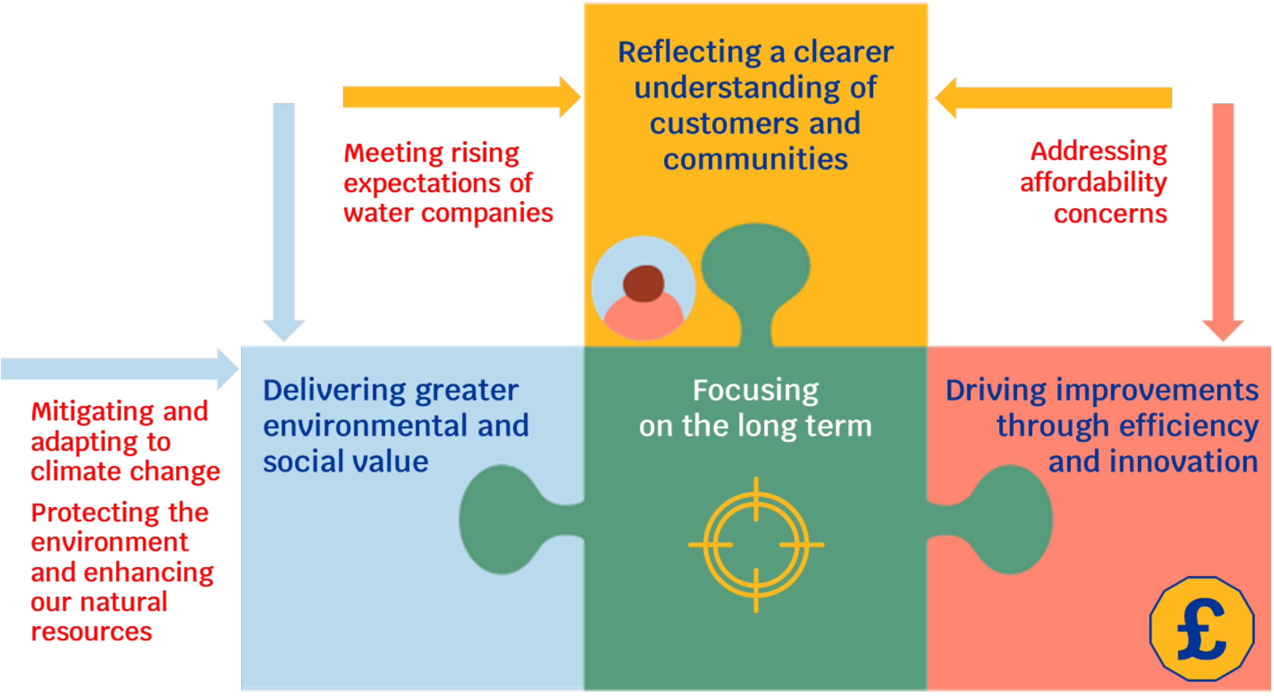
[4] Ofwat, 'Delivering UK government priorities for the English water sector through our 2024 price review final methodology', December 2022; Ofwat, 'Delivering Welsh Government priorities for the English water sector through our 2024 price review final methodology', December 2022.
[5] Defra, 'The government's strategic priorities for Ofwat', February 2022.
[6] Secretary of State for Business, Energy and Industrial Strategy, 'Strategic priorities and cross-sectoral opportunities for the utilities sectors: open letter to regulators', January 2022.
[7] Welsh Government, 'Strategic Priorities and Objectives Statement to Ofwat issued under section 2B of the Water Industry Act 1991', December 2022.

- delivering **greater environmental and social value**;
- reflecting a **clearer understanding of customers and communities**;
- driving improvements through **efficiency and innovation**; and
- increasing **focus on the long term**.

Stakeholders agreed with the challenges we identified in our draft methodology and our proposed ambitions for PR24 to help address them, which are summarised in Figure 2.1.

Figure 2.1 Key challenges and our ambitions for PR24



2.4 Our toolkit for meeting the challenges

To meet the challenges set out above, we will use a wide range of regulatory tools. The price review is one of our key tools for encouraging better performance – but, as we explain below, it works alongside wider activities we carry out day-to-day. It is important that companies do not wait until PR24 to step up and deliver against expectations.

We choose the most effective tool depending on the issue at hand. All these elements support each other to improve outcomes for customers and the environment. And, in turn, they support the activities of other regulators and stakeholders in the sector, who contribute towards meeting the challenges we all face.

2.4.1 PR24

The price review is one of our key regulatory tools. It is based around three complementary 'building blocks': outcomes, costs and risk and return. We will maximise the effectiveness of these building blocks by incentivising high-quality, ambitious company business plans, and taking proactive steps to strengthen customer and stakeholder voices. Overall, our approach will support, encourage and require companies to step up to meet customer and stakeholder expectations.

In their responses to our draft methodology, most stakeholders agreed that this high-level approach is the right one, although some environmental stakeholders questioned the effectiveness of the outcomes regime in driving the right behaviours. Many highlighted the importance of considering each element together as a package. And we received a range of feedback on how best to use these building blocks to deliver our ambitions at PR24. We consider these comments throughout this document and the relevant appendices.

Delivering the right outcomes

It is crucial that companies deliver the right outcomes for customers, communities and the environment. Our outcomes framework holds companies to account for the outcomes customers pay for, and incentivises them to go further where it will deliver value.

We will set 23 common performance commitments (PCs) at PR24 (15 for water-only companies). These will have a strong focus on customer service, the environment and asset health performance, including new measures to encourage improved outcomes for business customers. Companies may also propose a small number of bespoke PCs, for example to address specific local issues, or where we consider specific companies need to improve.

Where possible, we will set the same performance commitment levels (PCLs) across companies, so all customers receive the same level of service. We expect these levels to reflect stretching improvements from day-to-day base spending, as well as taking into account improvements from enhancement investments. And we will ensure these levels enable a sensible path towards meeting the sector's long-term targets, such as on leakage and net zero.

We will incentivise outcomes through outcome delivery incentives (ODIs). This means customers receive payments if companies underperform against their PCLs, and companies receive payments if they outperform. Most of these incentives will be set using the results of collaborative customer research. To encourage companies to innovate to deliver major performance improvements, we will also set enhanced incentives for those PCs that are likely to deliver the greatest benefits for customers and the environment. To limit overall risk to customers and companies, payments will be shared between customers and companies if total payments reach certain thresholds.

Customer service in the water sector needs to improve. We want to see companies deliver a step change in customer service – for all customers, and especially those who are worst-served. Companies should put forward proposals to deliver this, which could influence their expenditure proposals and forecasts. We are increasing the amount of money at stake for performance on the customer measure of experience (C-MeX) incentive. And, before the draft determinations, we will work with stakeholders to develop the detailed design of C-MeX, alongside our range of regulatory tools to support all customers. We will also review the measure of experience for developer services (D-MeX) and introduce a new measure of experience for business customers (BR-MeX).

Setting expenditure allowances

We scrutinise companies' submissions to ensure customers do not pay more than they need to for the service they receive. At PR24, we will build on our established approach to expenditure assessment. To set allowances, we use the most efficient companies to set benchmarks for what other companies can achieve. We then incentivise companies to be efficient and innovative, by ensuring they bear some of any overspend and allowing them a share of any underspend.

Our expenditure assessment will support, encourage, and require companies to transform their performance and rebuild trust and confidence in the sector. To keep bills affordable, companies need to stretch themselves to improve service from existing allowances. They must demonstrate they are doing so before we provide additional allowances at PR24.

Companies' day-to-day base allowances will reflect the efficient costs of delivering resilient services over the long term. We consider that historical allowances have been sufficient to maintain and improve outcomes. At PR24, we will better reflect forward pressures in our approach and will adjust allowances where increasing risks require additional funding.

We will also facilitate efficient enhancement investment, in the short and long term. To enable this, companies will set their five-year business plan in the context of their 25-year long-term delivery strategy, showing how they expect to deliver long-term objectives in a range of plausible futures. We will hold companies to account for the timely delivery of the outcomes and outputs they promise, by introducing price control deliverables (PCDs).

To protect and enhance our environment, we will encourage companies to make fast progress towards meeting government targets and priorities. The impact of storm overflows on our rivers is not acceptable. We expect all companies to reduce their use of storm overflows and, where appropriate, go beyond an annual average of 20 spills per overflow from 2025 onwards, without additional expenditure allowances. We will provide extra funding to reduce harm from storm overflows, where government targets demonstrably go beyond current legal requirements. We are introducing a net zero challenge, providing extra allowances to companies that propose the most efficient and mature approaches to emission reduction. Companies should deliver national long-term leakage targets. And those with higher leakage levels should challenge themselves to go beyond these targets – or we will intervene to ensure they do so.

We want companies to deliver greater social and environmental value, so they can deliver more for the funding that customers provide. This includes making a step change increase in the use of nature-based rather than traditional solutions. Our expenditure assessment will promote best value and take more explicit account of environmental and social factors. We will provide a 10-year allowance for non-traditional opex-based schemes, and reward companies that reduce costs by delivering wider benefits, for example through partnerships.

We will retain and expand the Innovation Fund, to at least £300 million, to help spur innovation across the sector. We will also introduce a fund of up to £100 million for companies to help their customers to use water more efficiently.

Aligning risk and return

We aim to align company and investor interests with those of customers. This ensures the sector is attractive to investors, but companies only earn high returns from great performance.

In setting the allowed return on capital, we will ensure investors receive a reasonable return, but that customers will not bear unnecessarily high bills at PR24 and beyond. Our 'early view' allowed return for PR24 is 3.29% (CPIH, real). We expect companies to use this allowed return or provide compelling evidence that another rate is more appropriate. This estimate is based on:

- a fixed cost of equity allowance of 4.14%, set at the midpoint of our range derived using the capital asset pricing model (CAPM);
- a cost of debt allowance of 2.60%, based separate allowances for embedded debt and a separate, indexed component for new debt; and,
- notional gearing of 55%.

The allowed return on equity is set on the basis of a fixed allowed return on equity, with a risk free rate that draws on one month's data to 30 September 2022. We keep open the option of using a different trail of historical data for draft and final determinations, reflecting the evolution of interest rates.

Our 'early view' has been set in a period that has been impacted by volatility in interest rates and we illustrate that the allowed return would be 3.53% (CPIH, real) based on a 31 October cut-off. We keep open the option to re-open the question of risk-free rate indexation should the recent volatility in interest rates persist into 2024.

We will set notional gearing at 55%, which is five percentage points lower than PR19. We consider such gearing reduction is achievable for the notional company ahead of 2025, taking account of the benefits of high inflation for equity in the current regulatory period. Signalling our decision now provides companies the opportunity to revisit and align their structures with the notional level ahead of PR24, should they wish to.

We expect companies to submit business plans accompanied by Board assurance that the plan is financeable on the basis of the notional structure. We will continue to use PAYG and RCV run-off for companies to recover their costs from customers over time. We will assess PAYG and RCV run-off rates proposed by companies in business plans. RCV run-off rates should set out their proposed run-off rates by reference to a framework which takes account of intertemporal fairness, affordability, our guidance on upper limits and financeability. We will fully index the RCV to CPIH from the start of the 2025-2030 period, ensuring that bills are no longer influenced by the discredited and upwardly-biased RPI measure.

Companies will need to provide Board assurance and supporting evidence to demonstrate their plans are set within the context of maintaining financial resilience of the actual company structure in 2025-30 and in the long term. Companies will need to demonstrate their proposed policies on dividends and performance-related executive pay will meet our expectations in 2025-30.

In July, we consulted on proposals to strengthen the regulatory ring-fence in companies' licences.[8] Our ambition is that these protections from risky financial structures will be achieved through the licence and through regular company monitoring and our work is ongoing. However, we may apply an incentive-based mechanism within the price review if we are not satisfied with progress achieved through other means. Should we pursue this, we will consult on the mechanism before, or alongside, our draft determinations.

To underscore our expectations with respect to performance-related pay awards, including the exercise of judgement by remuneration committees with respect to overall performance delivery, we are considering introducing a new end-of-period reconciliation mechanism. This would allow us to adjust revenue allowances, so that customers no longer fund such awards if companies are unable to demonstrate their decisions reflect our expectations. We will engage with the sector and wider stakeholders on the implementation of this mechanism.

We encourage companies to put forward voluntary sharing mechanisms where companies or investors receive disproportionate outperformance benefits at customer expense.

Reflecting customer views

We are doing more than ever to reflect customer and stakeholder views in the price review. We are working with companies and CCW to conduct collaborative customer

[8] Ofwat, 'Consultation under sections 13 and 12 A of the Water Industry Act 1991 on proposed modifications to strengthen the ring-fencing licence conditions of the largest undertakers', July 2022.

research to inform common areas of business plans. We also expect companies to undertake further engagement as necessary, to ensure submissions are informed by stakeholder views.

Customers, communities and wider stakeholders will have the opportunity to put their views to companies first-hand, in two open challenge sessions. The first 'Your Water, Your Say' / 'Eich Dŵr, Eich Llais' session will feed into the company's development of the business plan, and the second will provide views on the business plan that the company submits in October 2023.

A collaborative approach in Wales

Although the regulatory frameworks and price review processes for water companies in England and Wales are broadly similar, we are ensuring that our ways of working reflect the circumstances in each country. We are required to act in accordance with the Welsh Government's SPS when we set price controls for Welsh water companies in 2024 and in carrying out our other relevant functions relating wholly or mainly to Wales.

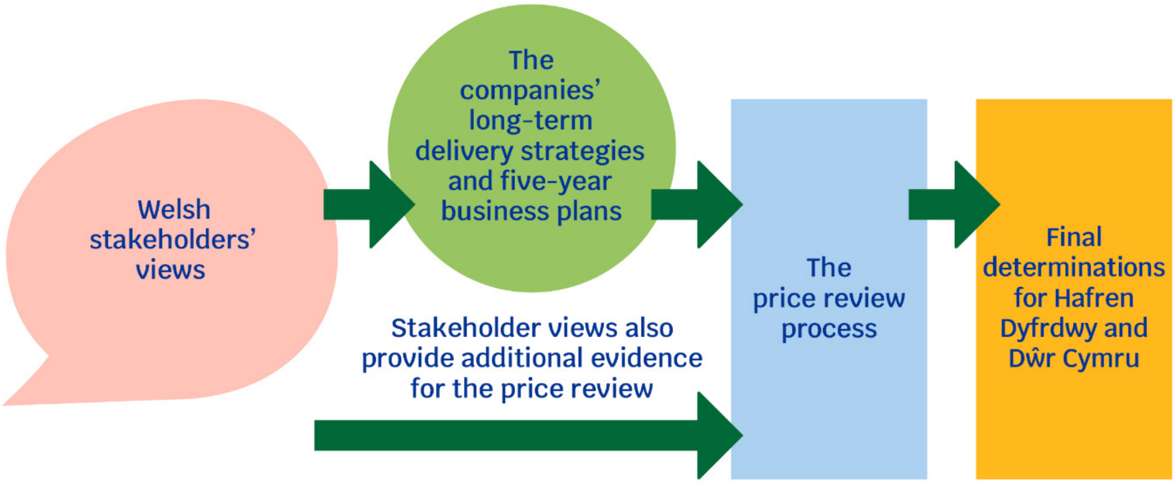
The Welsh Government has framed the SPS in the context of the Well-being of Future Generations (Wales) Act 2015 and its Programme for Government 2021-2026. We take account of these, and other relevant legislation which places a particular focus on outcomes that deliver for the environment, the economy and society.

The SPS also focuses on meaningful engagement with stakeholders and an expectation on how this engagement should happen, with a focus on 'collaboration'. **We have implemented a collaborative approach that is identifying the high-level outcomes to be achieved in Wales** and the phasing of these outcomes within the long-term delivery strategies for Welsh companies. This is mobilised through the Wales PR24 Forum. We have set out the expected ways of working and how we will integrate the collaborative approach into PR24, and how this enables us to reflect the specific circumstances in Wales.[9] The Forum has identified and discussed key issues for Wales and the Welsh companies for PR24, and it will use this important groundwork to provide strategic steers on the high-level outcomes and priorities. Companies will feed these into their plans and long-term delivery strategies. We will continue to support the Forum as an advisory member.

We see the collaborative approach in Wales as an iterative process where the appropriate balance of outcomes can be discussed and developed. Figure 2.2 sets out, at a high level, how this is happening, and how it is feeding into the price review process. We expect the collaborative approach to take account of customers' concerns about the affordability of business plans and long-term delivery strategies.

[9] The following stakeholders are involved: Welsh Government, Natural Resources Wales, Drinking Water Inspectorate, CCW, Ofwat, Dŵr Cymru and Hafren Dyfrdwy. CCW has published terms of reference for the Forum.

Figure 2.2 The collaborative approach in Wales



Encouraging quality and ambitious business plans

We incentivise companies to produce high-quality, ambitious business plans. This benefits customers, communities and the environment, because we can then scrutinise submissions more effectively, and we will use the best submissions to push forward the performance of the whole sector.

We will assess company plans at PR24 according to a range of criteria. Where companies demonstrate quality and ambition, they will be rewarded – and where quality or ambition are insufficiently demonstrated, the company will receive penalties.

2.4.2 Our wider toolkit

In addition to the price review, we have a wide range of regulatory tools to help drive the sector to meet the challenges we face. These include markets, licensing and enforcement, assurance, monitoring, campaigns, and partnerships. We also operate alongside quality and environmental regulators in the sector, and coordinate and collaborate with our partners in the interests of customers, communities and the environment.

We often use these wider tools in combination with the price review process to deliver the most effective approach. For example, within the price review, our outcomes framework incentivises companies to deliver great performance, including service beyond legal obligations where appropriate. Through our wider regulatory tools, we hold companies to account for their performance by monitoring them outside the price review, and use enforcement action where performance falls significantly short and breaches relevant legal obligations.

Stakeholders generally considered that our draft methodology proposals struck the right balance between what is in and what is outside of the price review.[10] Some respondents expressed concern about how we were addressing affordability and vulnerability and stated that we should focus more on these issues in the price review. Some called for greater clarity on how the tools inside and outside the price review will interact to address these issues. We address these responses below.

Addressing affordability and vulnerability through our toolkit

We are clear that companies should not wait until PR24 to act on affordability challenges. We are acutely aware of the enormous challenges facing households, including vulnerable customers. We have set out to companies our expectations for supporting customers through these cost of living pressures.[11] And we are using tools inside and outside the price review to encourage companies to deliver affordability and value for money.[12]

PR24 is our primary tool for regulating companies to deliver overall affordability, value for money, and affordability for current and future customers. Companies should support affordability, by:

- taking a **long-term focus** to reduce lifetime costs and phase investments over time;
- finding **new ways of working**, and working in partnerships to deliver more for customers;
- clearly **understanding customers' views**, including their expectations about bills today compared to the future;
- clearly **understanding and supporting customers' diverse needs on a day-to-day basis**, not just for a price review;
- balancing the recovery of costs between **different generations of customers**;
- reporting on how they plan to support **customers struggling to pay**; and
- innovating and delivering a step change in **efficiency**.

We will scrutinise company submissions to ensure that current and future customers do not pay more than they need to for the services they receive. We will also assess whether each company meets our minimum expectations of testing customers' views around the affordability and acceptability of its plan, and reward those which demonstrate ambition to further enhance affordability. We expect companies to consult with the full diversity of their customer base as they develop their plans, including vulnerable customers.

Alongside these measures at PR24, we are using our wider toolkit to address affordability and vulnerability. A key change will be the introduction of new rules for how

[10] We received some comments around the scope of developer services within price controls, which are addressed in chapter 3.
[11] Ofwat, CCW, 'Supporting customers through cost of living pressures', October 2022.
[12] We explain our approach in Appendix 1 – Affordability.

companies treat customers, through a customer-focused licence condition.[13] We have also taken action to strengthen our expectations for how companies should treat customers struggling to pay.[14] And our charging rules support affordability by giving companies flexibility around how they charge customers. We have recently consulted on innovation in charges to support affordability, such as using rising block tariffs, which can help lower bills for households with essential water use.[15]

Outside of PR24, we will ensure companies continue to report on vulnerability on a consistent basis. We will also consider how they may do so on affordability. Reporting outside of the price review allows greater flexibility to respond to economic and societal circumstances.

2.5 How we will evaluate the impact of PR24

The appendices to this document set out the rationale behind our decisions and our expectations of the likely impacts of our policies.[16] Any future evaluation of PR24 will use these impact assessments as a starting point.

Stakeholders broadly agreed that we should evaluate the impact of PR24. There were some suggestions as to how an evaluation should be undertaken and how it should be structured. In particular, the following overall themes were raised:

- several respondents agreed we should use our ambitions for PR24 as the basis for an evaluation. Others stated that we should use a wider set of criteria, for example to consider the UK and Welsh Governments' SPSs for Ofwat, our statutory duties, and/or the outcomes framework, in assessing the impact of PR24;
- some stakeholders called for us to consider the timing of an evaluation. A review during the course of the 2025-30 period could look at the process of PR24, but in terms of impact, a longer timeframe should be considered and an evaluation undertaken after 2030. This could look back over PR14 and PR19, alongside PR24, to review changes to the regulatory framework and how companies have responded to these changes; and
- several respondents called for any evaluation to be carried out by an independent organisation.

We intend to use our ambitions for PR24 as the basis for any future evaluation work. These ambitions were developed in the context of our statutory duties, and the framework will allow us to address them, and the SPSs, where appropriate. We will continue to develop our plans for evaluating PR24, including to engage further with the sector, taking into consideration

[13] We are planning to introduce a new principles-based licence condition, which will provide a clear regulatory basis for the requirement for water companies to treat customers fairly, including by providing support to customers in vulnerable circumstances. Ofwat, 'Customer-focused licence condition'.
[14] Ofwat, 'Paying fair – guidelines for water companies in supporting residential customers pay their bill, access help and repay debts', May 2022.
[15] Ofwat, 'Consultation on charging innovation to support affordability', September 2022.
[16] Our impact assessments are set out in Appendix 14, 'Impact assessments'.

the comments already expressed. We recognise the importance of ensuring any evaluation is proportionate and delivers useful, credible and robust outputs to stakeholders.

3. Design and implementation of price controls

3.1 Introduction and summary

This chapter sets out our approach to:

- Design of controls (Section 3.2);
- Regulatory forecasting incentive mechanism (Section 3.3);
- Water resources (Section 3.4);
- Developer services (Section 3.5);
- Retail (Section 3.6);
- Bioresources (Section 3.7); and
- Direct procurement for customers (Section 3.8)

Further information on topics covered in this chapter, including detailed consideration of responses to our draft methodology, is set out in:

- Appendix 2: water trading incentive;[17]
- Appendix 3: developer services;[18]
- Appendix 4: bioresources;[19] and
- Appendix 5: direct procurement for customers.[20]

3.1.1 Key messages

- We are retaining separate controls for water resources, network plus water, network plus wastewater, residential retail, business retail (for Welsh companies only) and bioresources.
- We will set a revenue forecasting incentive mechanism that covers the water resources and network plus water and wastewater controls.
- We are removing the requirement for companies to set out risk sharing mechanisms with customers for large water resource infrastructure. We will not use the Bilateral Entry Adjustment Mechanism for the 2025-30 period.
- We will remove wastewater site-specific developer services from the wastewater network plus price control at PR24.

[17] Ofwat, 'Creating tomorrow, together: Our methodology for PR24, Appendix 2: water trading incentive', December 2022.
[18] Ofwat, 'Creating tomorrow, together: Our methodology for PR24, Appendix 3: developer services', December 2022.
[19] Ofwat, 'Creating tomorrow, together: Our methodology for PR24, Appendix 4: bioresources', December 2022.
[20] Ofwat, 'Creating tomorrow, together: Our methodology for PR24, Appendix 5: direct procurement for customers', December 2022.

- For English water companies at PR24, water site-specific developer services will be removed from the water network plus price control at PR24, but they will still be subject to our charging rules.
- For Welsh water companies at PR24, water site-specific developer services will remain in the water network plus price control because competition is less widespread and we do not have powers to establish charging rules to protect developer services customers.
- Network reinforcement will remain in the water and wastewater network plus price controls at PR24.
- To protect retail customers not eligible for competition, we will set a five-year average revenue control for the residential retail activities of English and Welsh companies and for the business retail activities of Welsh companies. Expected input price pressure can be reflected in the revenue limit we set for companies at the outset of the price control.
- We will set a more market-oriented control for bioresources. We will set an average revenue control, a separate efficiency challenge for bioresources (and wastewater network-plus) and include growth enhancement expenditure in our econometric cost benchmarking models.
- Direct procurement for customers (DPC) will apply by default in companies' PR24 business plans for all discrete projects over £200m of whole life totex.

3.2 Design of controls

3.2.1 Summary

At PR24 we are:

- Retaining separate controls;
- Setting water resources and network plus as total revenue controls; and
- Setting retail and bioresources as average revenue controls.

For each control we will:

- Set efficient total expenditure allowances (totex);
- Assess in-period expenditure and additions to Regulatory Capital Value (RCV);
- Calculate returns on, and run-off of, RCV; and
- Include a tax allowance

3.2.2 Responses to our draft methodology

We received 12 responses from stakeholders that related to the design of controls or observations on our approach to price controls. While six stakeholders explicitly expressed support for our proposed approach, noting the benefits of consistency and retaining the current control boundaries, there was no consistent theme in the other comments raised. Comments included:

- Support for our approach to the separate Thames Tideway and Havant Thicket controls;
- That there is a greater scope for the use of markets beyond our proposals; and
- That we have not published an analysis of the benefits of separating price controls.

3.2.3 Key changes from our draft methodology

Having considered stakeholder responses, our policy positions remain as stated in the draft methodology. We have considered where there is scope to make greater use of market mechanisms where these will lead to benefits for customers. In PR24 we are moving some developer services out of price controls (see Section 3.5) and are setting a more market-oriented bioresources control (see Section 3.7) and we have made some changes from our draft methodology proposals in these areas.

We note that we reviewed the separation of wholesale and retail controls in Chapter 7 of our PR14 Review.[21] We also considered the benefits of further separating price controls in the final methodology for PR19, although this was the scope of benefits before the separation took place.[22] We noted when deciding against changing the boundary of the water resources control at PR24 that the changes to the control boundaries were very recent, meaning we had little data to assess their impact.[23]

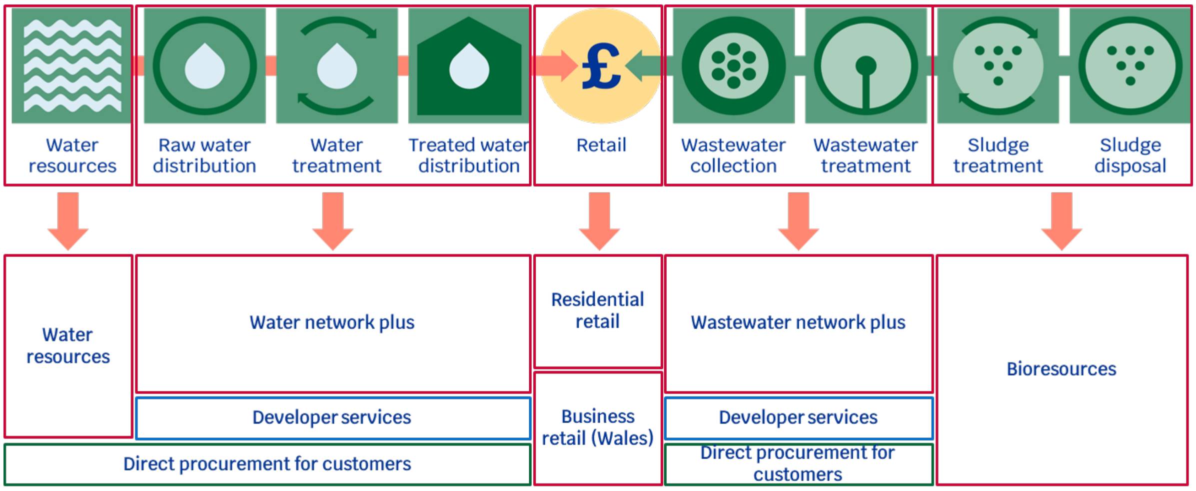
3.2.4 Our final methodology for the design of price controls

We will set the following separate revenue controls at PR24:[24]

- water resources;
- network plus water;
- residential retail;
- business retail (for Welsh companies only);
- network plus wastewater (for wastewater companies only); and
- bioresources (for wastewater companies only).

[21] Ofwat, 'PR14 Review', January 2022.
[22] Ofwat, 'Delivering Water 2020: Our final methodology for the 2019 price review Appendix 5: Water resources control', December 2017 and Ofwat, 'Delivering Water 2020: Our methodology for the 2019 price review Appendix 6: Bioresources control', December 2017.
[23] Ofwat, open letter 'Water resources price control boundary', 17 November 2021.
[24] We also intend to set separate controls for Thames Water for its activities in relation to the Thames Tideway Tunnel and for Portsmouth Water in relation to the development of the Havant Thicket reservoir.

Figure 3.1 Water and wastewater activities



Each revenue control will be set on a 'single till' basis. We will forecast the efficient costs of companies and set a revenue allowance which allows well managed companies to recover those costs for a basket of services, including through charges to end customers.

We will include a number of uncertainty mechanisms[25] which allow for adjustments to be made to companies' revenues or to their RCV. These adjustments may take place either 'in-period' (after the end of a given price control year) or at the end of the 2025-30 period. We include these mechanisms to make sure that risks are properly allocated between companies and their customers and that customers' interests are appropriately protected. Adjustments can also improve company incentives (such as around their revenue forecasting).

We will set the water resources, network plus water and network plus wastewater controls as total revenue controls. This means we will set controls that allow companies to recover a fixed total amount of revenue from their customers for these activities. We will set the retail and bioresources controls as average revenue controls. This means we will set an average revenue (for example per customer, in the case of retail) that each company may recover for providing these services. In both cases this allows companies flexibility in how they recover this revenue, subject to the revenue cap, our charging rules and any other relevant legal obligations.

We will set the revenue each company can recover for the 2025-30 period by determining:[26]

- our assessment of efficient expenditure (referred to as total expenditure (totex));
- the assessment of expenditure to be recovered within the period (set as the pay as you go (PAYG) ratio) and that which should be added to the RCV and recovered in the future by companies;

[25] A summary of the mechanisms is contained in Ofwat, ['PR24 Final Methodology – Appendix 11 Allowed return on capital'](), December 2022
[26] Chapter 6 sets out our approach to assessing the efficient costs for the wholesale controls. Chapter 7 discusses how we will set an appropriate return for the wholesale controls, and our approach to tax. Chapter 8 sets out our approach to recovering costs, which determines the PAYG rates and RCV run-off for the wholesale controls.

- returns on, and run-off of, the RCV;[27] and
- a tax allowance.

3.3 Revenue forecasting incentive mechanism

3.3.1 Summary

At PR24 we will set a revenue forecasting incentive (RFI) mechanism that:

- Covers the water resources and network plus water and wastewater controls, but not the bioresources control, retail controls and site specific developer services revenues;
- Is a symmetric revenue adjustment applied in-period to true-up revenue differences; and
- Makes a time value of money adjustment.

3.3.2 Responses to our draft methodology

Most stakeholders that commented, largely affected companies, supported the retention of the RFI, although two proposed its removal. A small number of stakeholders, including representatives of customers, questioned its effectiveness. A number of companies raised a variety of issues around the detailed operation of the RFI, including revenues which should be excluded from its application.

3.3.3 Key changes from our draft methodology

We have noted that most stakeholders either support the retention of the RFI or did not comment. We continue to consider that the RFI provides protections for both customers and companies and we will retain it for PR24. We have considered the detailed points raised by companies and the representations that have been made on certain exclusions. We consider that these are largely relevant to the operational rules and will therefore consider them when we refine the detail of the mechanism's design ahead of our final determinations. As a consequence, we will also give further consideration to our approach to applying penalties and the associated "dead band" (a margin of error around the forecast within which a penalty would not apply).[28]

[27] Arrangements for RCV differ for the bioresources control. See Section 3.7.
[28] Since an incentive mechanism with a penalty has been in place, company revenue forecasting has improved. See: Ofwat, 'PR14 Review', January 2022, p. 93.

3.3.4 Our final methodology for the RFI

Companies set charges in advance based on the best information available to make sure that their expected revenues are aligned with the revenues allowed under their controls. However, many factors may cause collected revenues to vary from the limits set by the controls. Some are controllable by companies, such as forecast accuracy, and others are less controllable, such as the impact of weather on demand.

The RFI acts as a 'correction mechanism' that allows companies to 'true-up' for under or over-recovered revenues in any year of the control period, rather than at the end of the review period. This benefits customers by smoothing bill variations and benefits companies by giving extra protection against revenue variance (something which is not available to companies in the wider economy). We want companies to take responsibility for providing accurate forecasts of their revenue. As companies cannot entirely control demand risks, we may apply a small but meaningful financial incentive to each year's revenue to focus management attention in this area.

We will set an RFI for the 2025-30 period in a similar form to PR19.[29] However, in line with the removal of some developer services from the price control, we will exclude site specific developer services revenue. The RFI will:

- cover the water resources and network plus water and wastewater controls, but not the bioresources control, site specific developer services revenue, or retail controls;
- be a symmetric revenue adjustment applied in-period to true-up revenue differences; and
- make a time value of money adjustment.

We will take account of stakeholder comments as we continue to review the detailed operation of the 2020-25 period RFI ahead of our final determinations in 2024, so that we can, if necessary, improve the RFI for the 2025-30 period to make sure that it operates as effectively as possible. Proposed changes will be set out in our draft determinations.

We will include factors within the RFI formula set at PR24 to allow 2024-25 blind year revenue adjustments to be recovered during 2025-30. We anticipate that this will be of similar form to those used for 2019-20 blind year revenue adjustments.

In November 2022 we issued a decision document which sets out the extent to which companies are able to recoup relevant un-invoiced revenue for services provided to a retailer in the event of a retailer's unplanned exit from the business retail market.[30] In our decision we explained that un-invoiced revenue should be subject to the relevant company's

[29] We explained our rationale for the design of the RFI in PR19 in Section 4.2 (pp. 29-33) of: Ofwat, 'Delivering Water 2020: Our methodology for the 2019 price review Appendix 7: Network plus water and wastewater controls', December 2017.
[30] Ofwat, 'Business Retail Market: Dealing with un-invoiced Wholesaler charges in the event of an unplanned Retailer exit', November 2022.

underperformance cost sharing rate before any amounts are recovered via an adjustment to the RFI. We intend to introduce a mechanism during PR24 to allow for in-period adjustments relating to un-invoiced revenue, similar to the approach outlined in the September 2021 consultation.[31]

3.4 Water resources

3.4.1 Summary

- We are retaining a total revenue control for water resources, with the same control boundaries as at PR19;
- We are removing the requirement for companies to set out risk sharing mechanisms with customers for large water resource infrastructure. We will not use the Bilateral Entry Adjustment Mechanism for the 2025-30 period; and
- We are retaining other features, including the bidding market and the water trading incentive, to encourage the efficient trade of water where it is in customers' interests and consistent with applicable UK government and Welsh Government guidance. We intend to introduce an adapted form of the water trading incentive from PR29.

3.4.2 Responses to our draft methodology

Most respondents agreed with our proposals to roll forward the current water trading incentive for PR24 and introduce an adapted trading incentive from PR29. Respondents' views on the water trading incentive are discussed in more detail in Appendix 2 – Water trading incentive.

Respondents were generally supportive of our wider approach to water resources set out in the draft methodology. However, a number of consumer and environmental stakeholders commented that our focus appeared concentrated on supply side measures and insufficiently addressed demand side measures and the critical importance of improving water efficiency.

3.4.3 Key changes from our draft methodology

Having considered stakeholder responses, our policy positions remain as stated in the draft methodology. We note stakeholder comments on the importance of water efficiency. We note that setting the price control as a total revenue control provides incentives for water efficiency as companies still recover the same amount of revenue, even if they reduce

[31] Ofwat, 'Business Retail Market: Proposals to deal with un-invoiced Wholesaler charges in the event of an unplanned Retailer exit', September 2021. Condition B allows us to set a new RFI formula for the 2025-30 period by 31 December 2024. The precise nature of this will form part of our wider development of the RFI for 2025-30.

demand. Measures to reduce water consumption have a very significant role to play in ensuring that companies have resilient water supplies and reducing water stress in the environment. In Chapter 6 and Appendix 9 - Setting expenditure allowances we set out how we will introduce a new fund for companies to help the development of transformative improvements to water efficiency at a regional and national level to help to reduce demand for water.[32] In Chapter 5 and Appendix 7 – Performance commitments we set out how we have now decided to set separate stretching performance commitments that require companies to focus on reducing leakage and promote water efficiency to both residential and commercial customers.

3.4.4 Our final methodology for water resources

We will retain the current boundary for the water resources control for the 2025-30 period. We recognise that there may be benefits associated with changing the control boundary in future and we may make changes at future price reviews to respond to developments in the water resources market.

We expect companies to be innovative and ambitious in seeking ways to meet customers' needs for new water resources in an affordable and environmentally sustainable way, including the consideration of demand side measures that reduce average consumption and leakage.[33]

We are retaining the bidding market, which allows third parties to bid to help companies meet and/or manage future demand for water. We expect companies to actively consider a wider range of options, such as trades with neighbouring companies and third parties and demand side options which may include demand management and leakage reduction services, to address supply-demand balance deficits. We require companies to publish a bidding framework against which they assess bids to provide water resources or demand management initiatives from third parties.[34]

As we are not currently anticipating bilateral market entry during the PR24 period, **we will not use the bilateral entry adjustment mechanism (BEAM)**.[35] We may reintroduce a BEAM when needed to support a future bilateral market.

We are retaining the water trading incentive, in its current form, until the end of March 2030. Further details on the water trading incentive, including the changes that we

[32] Outside of the price review process, we have consulted on how water companies could use innovation in household charges to support various goals, including greater water efficiency. Ofwat, 'Consultation on charging innovation to support affordability', September 2022.
[33] Water companies have targets to deliver a 50% reduction in leakage from 2017 to 2018 levels by 2050 and to help their customers reduce personal water consumption to 110 litres of water per head per day by 2050.
[34] Ofwat, 'Company bid assessment frameworks.'
[35] "Bilateral markets" is the term for the proposed market model that would see third parties trade water resources directly with retailers in the business market (usually using an incumbent water company's network to treat and transport the water.)

intend to bring in from PR29, can be found in Appendix 2 - Water trading incentive. Any water transfers from Welsh water companies to English water companies must align with the Welsh Government's Water Resources Management Plan guidance.[36]

We will treat investments in water resources assets in line with our general policy for water and wastewater assets, in terms of inclusion in the RCV. This means that, in a change from PR19, **we will not require companies to specify utilisation risk-sharing arrangements** for large investments in water resource assets.

3.5 Developer services

Developer services describes the activities delivered to connect new houses and businesses to the water and/or wastewater network. Around 200,000 new properties are connected to the water network every year across England and Wales. Developer services revenue accounted for 4.4% of network plus allowed revenue at PR19.

Developer services can be broken down into site-specific and network reinforcement work. Site-specific work includes new connections, water mains and sewer requisitions, and diversions under section 185 of the Water Industry Act 1991 (section 185 diversions). Network reinforcement includes the provision or upgrading of network assets to supply new customers with no net deterioration of levels of service for existing customers.

Network reinforcement work is mostly delivered by the incumbent company. But site-specific work is mostly contestable and can be provided by the incumbent, a new appointee, or a self-lay provider (SLP).[37] SLPs and new appointees may provide faster, more responsive services and lower prices than incumbents.[38] They can also sometimes provide developer services across utilities, reducing coordination issues.[39]

At PR19, developer services revenue was included within the water and wastewater network plus price controls, with the aim of driving cost efficiencies and preventing companies from overcharging developer services customers. We also:

- introduced a developer services revenue adjustment (DSRA) mechanism, which adjusts allowed revenue if the actual number of connections is more or less than forecast, mitigating volume risk; and

[36] Welsh Government, 'Guiding Principles for Developing Water Resources Management Plans 2022', note particularly Section V (pp. 7-8), December 2021.
[37] Much non-specialist work such as excavation or sewer laying is typically carried out by developers or their contractors.
[38] Ofwat, 'Review of incumbent company support for effective markets', August 2020, pp. 30-31.
[39] Ofwat, 'Review of incumbent company support for effective markets', August 2020.

- introduced the developer services measure of experience (D-MeX) incentive mechanism to encourage water companies to provide good service quality to their developer services customers, SLPs and new appointees.

We said we would revisit our regulation of developer services at PR24 given growth in the services being provided by SLPs and new appointees.

3.5.1 Summary

We summarise the key aspects of our approach to regulating developer services at PR24 below. We are making several changes to our approach to help the development of competition in the developer services market. This includes removing regulation where it is no longer required and focusing regulation in areas where it will provide the most benefits to developer services customers.

Wastewater site specific developer services

- Wastewater site-specific developer services will be removed from the wastewater network plus price control at PR24 as they are almost entirely provided by alternative providers or self provision.

Water site specific developer services

- For English water companies at PR24, water site-specific developer services will be removed from the water network plus price control, but they will still be subject to our charging rules. The exception is section 185 diversions, which will remain in the water network plus price control as they are not currently contested.
- For Welsh water companies at PR24, water site-specific developer services will remain in the water network plus price control because competition is less widespread and we do not have powers to establish charging rules to protect developer services customers.

Network reinforcement

- Network reinforcement remains in the water and wastewater network plus price controls at PR24 as it is not currently contested and is more difficult to separate from other company activities.
- Network reinforcement will be included in the scope of cost sharing at PR24 to help manage uncertainty around the volume and mix of network reinforcement work to be delivered, and to incentivise cost efficiency.

3.5.2 Responses to our draft methodology

We received responses from water companies and other developer services stakeholders on our developer services draft methodology proposals.

Wastewater site specific developer services

There was broad agreement from incumbent companies that wastewater site-specific developer services should be removed from the wastewater network plus price control, noting most of these services are competitive and usually delivered by the developer.

Other developer services stakeholders, including developers, SLPs and new appointees, raised concerns that it could lead to lower levels of service quality in the small number of cases when the developer must use the incumbent wastewater company.

Water site specific developer services

Incumbent companies mostly think that water site-specific developer services should be removed from the control in full, with alternative protections put in place through charging rules. They think splitting the market based on development size, as proposed in our draft methodology, would be overly complex,[40] create perverse incentives,[41] and is not aligned to how companies set charges. Some incumbent companies suggested distinguishing between developments that do, and do not, require new water mains instead. They said this would be more aligned with how companies set charges and is a key driver of whether a development is attractive to SLPs and new appointees.

Other developer services stakeholders (eg developers; SLPs; new appointees) do not think the market is sufficiently well developed to remove these services from the water network plus price control. They are concerned it would affect the competitiveness of SLPs and new appointees, and lead to lower levels of service quality from incumbent companies.

Network reinforcement

Respondents generally agreed that network reinforcement should remain in the network plus price controls at PR24. But several incumbent companies think the removal of network reinforcement from the price control should be a long-term goal to reduce the risk of cost cross-subsidisation to or from water bill paying customers.

Most respondents agreed that a separate network reinforcement reconciliation mechanism is not required if network reinforcement is included in cost sharing. But several incumbent

[40] For example, cost allocation challenges.
[41] For example, incentive to split developments up into smaller sizes.

companies argued that cost sharing is not sufficient because the volume of network reinforcement work depends on housing growth, which is uncertain.

3.5.3 Key changes from our draft methodology

In our draft methodology, we proposed to split the market for water site-specific developer services based on development size. After considering stakeholder responses, water site-specific developer services will instead be removed from the water network plus price control at PR24 for English water companies, but they will still be subject to our charging rules. The exception is section 185 diversions, which will remain in the water network plus price control as they are not currently contested.

The Welsh Government informed us that it was incorrect to assume in our draft methodology that the provisions enabling us to set charging rules will be in place for Welsh companies for the 2025-30 period. Water site-specific developer services will therefore remain in the water network plus price control for Welsh water companies at PR24 because we do not have powers to establish charging rules or widespread competition to protect developer services customers.

3.5.4 Our final methodology for developer services

Wastewater site-specific developer services

Wastewater site-specific developer services will be excluded from the wastewater network plus price control at PR24 because:

- Nearly all wastewater site-specific developer services are delivered by SLPs/developers. There appears to be no market power issue.
- Costs and revenue can be separated from other activities.

There are some instances where developer services customers must use the incumbent company to provide wastewater site-specific developer services. For example, on sites with access issues such as the need to cross a railway, where the incumbent company needs to use its statutory powers. We will consider ahead of the 2025-26 charging year whether any changes to charging rules are needed to protect customers in these instances. We also note that D-MeX will remain at PR24 to continue to incentivise incumbent companies to provide good service quality to developers, SLPs and new appointees.

Water site-specific developer services

We see benefits in removing water site-specific developer services from the water network plus price control: it reduces the risk of cost cross-subsidisation to or from water bill payers and subsequent market distortions; and removes the need for complex cost assessment and reconciliation mechanisms. But we need to make sure that developer customers are sufficiently protected against potential abuses of monopoly power (eg higher prices).

We therefore consider a mix of market and regulatory tools are required to achieve effective outcomes in relation to water site-specific developer services.

We will remove water site specific work from the price control for English water companies at PR24, but they will still be subject to our charging rules.[42] The level of competition from SLPs and new appointees is increasing, and there is a risk our regulatory approach is distorting the market. Charging rules can be more targeted to specific charges for new connection services and are also more flexible than price controls as they can be more easily amended if necessary. We will consult on potential changes to charging rules ahead of the 2025-26 charging year to make sure that developer services customers that have limited choice in the market are sufficiently protected. For example, development sites that do not require new water mains. We recognise that charging rules must enable incumbent companies to set and recover cost reflective charges. D-MeX will also remain at PR24 to continue to incentivise incumbent companies to provide good service quality to developers, SLPs and new appointees.

For Welsh water companies at PR24, water site specific developer services will remain in the water network plus price control because competition is not as widespread and we do not have powers to establish charging rules to protect developer services customers.

Water site-specific developer services will be included in the scope of cost sharing at PR24 for Welsh water companies to help manage uncertainty around the volume and mix of work to be delivered, and to incentivise cost efficiency.[43] We will also consider ex-post adjustments to allowed revenue in the PR24 end-of-period reconciliation if the actual volume and mix of new connections is materially different from forecast and could not have been expected when developing business plan forecasts.

Network reinforcement

Network reinforcement will remain in the network plus controls at PR24 because:

- It is almost entirely delivered by the incumbent companies, so competition is insufficient to protect new connection customers from monopoly power (eg higher prices).
- There are substantial interactions with other incumbent company activities (eg capital maintenance) that do not help with accurate cost separation.

[42] Water section 185 diversions will remain in the water network plus price control at PR24 as they are not currently contested. But we will include them in third-party services at PR24.
[43] Excluding section 185 diversions, which will be included in third party services.

- There can be substantial temporal mismatch between costs and revenue because reinforcement may take place before work begins on a development site.

Network reinforcement will be included in the scope of cost sharing at PR24 to help manage uncertainty around the volume and mix of network reinforcement work to be delivered, and to incentivise cost efficiency. Network reinforcement is relatively immaterial compared to site-specific connection services and is subject to less uncertainty given the long-term planning needs. So, we do not consider a separate network reinforcement revenue reconciliation adjustment is needed at PR24. There will therefore not be a developer services revenue adjustment mechanism for the 2025-30 period.

3.6 Retail

3.6.1 Summary

- We are setting a five-year average revenue control for the residential retail activities of English and Welsh companies;
- We are setting a five-year average revenue control for the business retail activities of Welsh companies;[44] and
- Expected input price pressure could be reflected in the revenue limit we set for companies at the outset of the price control.

3.6.2 Responses to our draft methodology

Stakeholders generally either supported or did not comment on the form of our retail controls. However, many water companies and WaterUK strongly disagreed with our proposal to retain our approach of not automatically indexing allowed retail revenue for inflation. Points raised by these stakeholders included that most retail costs vary with inflation; inflation risks would continue to lie fully with companies; high inflation would risk curtailing service improvements if companies reduce costs; and automatic indexation is a feature in the English business retail market.

3.6.3 Key changes from our draft methodology

Having considered stakeholder responses, our policy positions remain as stated in the draft methodology. Stakeholders generally supported or provided no comment on our proposals for the structure of controls in England and Wales. Although there were concerns about a lack of automatic retail indexation, any expected input price pressure can be reflected in the

[44] English water companies for whom we set individual price controls have all chosen to exit the business retail market and no longer carry out business retail activities.

revenue limit we set for companies at the outset of the price control instead. This approach provides appropriate incentives for retailers to manage input costs given they are best placed to manage them while still ensuring expected inflationary pressures on input prices can be reflected in companies' allowed revenues. It is appropriate for our PR24 retails controls which (unlike the Retail Exit Code covering the English business retail market) are for a pre-defined duration.

3.6.4 Our final methodology for retail controls

We protect retail customers not eligible for competition in England and Wales through a retail price control. At PR24 we will set an average revenue control based on the number of customers companies need to serve. This will be based on a retail cost to serve and net margin approach and will be expressed as:

- for the residential retail control of English and Welsh companies, an amount of allowed revenue for each residential retail customer; and
- for the business retail control of Welsh companies, an amount of allowed revenue for each business retail water customer and an amount of allowed revenue for each business retail wastewater customer.

This approach makes sure that companies' allowed revenue is linked to how many customers they need to serve (and therefore a key driver of their costs). We applied this approach for residential retail activities at PR19. For business retail, this approach is a simplification of the controls at PR19 which allowed for a greater number of tariff bands.

Expected input price pressure could, to the extent appropriate, be reflected in the revenue limit we set for companies at the outset of the price control. For example, if there is convincing evidence of significant projected increases in labour costs, we will consider making an adjustment for this. We will use this approach instead of automatic indexation of allowed revenue each year. This means that companies' allowed revenue will not change in line with the general level of inflation within the price control period. This approach provides appropriate incentives for retailers to manage input costs, given they are best placed to do so. This is similar to the approach we took at PR19.

There will be a reconciliation to correct for any over- or under-recovery of revenue over the 2025-30 period. This makes sure any imbalances are corrected in an appropriate and timely way. Any correction will incorporate a time value of money adjustment. This is a simpler version of the approach we applied to residential retail controls only at PR19.

The eligibility threshold for water retail competition (there is no wastewater retail competition) for business customers of Welsh water companies may increase.[45] Customers

[45] Welsh Government, 'Strategic Priorities and Objectives Statement to Ofwat issued under section 2B of the Water Industry Act 1991', July 2022.

above the current eligibility threshold will be brought within the control if the eligibility threshold rises.

We will not set a price control for the largest water customers of Welsh companies who can switch their supplier. This is consistent with our approach in the Retail Exit Code for large business customers served by English water companies who have been transferred to business retailers. Instead, the Retail Exit Code requires default tariffs for this group to be reasonable and not to be unduly preferential or discriminatory compared to customers of the same class. Welsh water companies are already subject to requirements in licence conditions not to show undue preference or undue discrimination when setting charges.

3.7 Bioresources

3.7.1 Summary

Bioresources (or sewage sludge) are the semi-solid by-products of wastewater treatment. Wastewater companies must make sure their bioresources are treated and disposed of appropriately.

- We expect companies to take a leadership role in developing the bioresources market and to fully exploit the opportunities it creates.
- We will set an average revenue control based on the amount of sludge companies produce. This is more akin to a 'gate price'.[46]
- We will assess companies' costs in a more market-oriented way. Growth enhancement costs will be assessed within our econometric models. We will set a separate efficiency challenge for bioresources (and wastewater network-plus).
- There will be no cost sharing for bioresources.
- We will implement an end-of-period reconciliation to help make sure companies collect the right amount of revenue and produce accurate forecasts of sludge production.

We plan to move to a 'fully reformed approach' at PR29.

3.7.2 Responses to our draft methodology

There was some support for our objective of moving to a more market-oriented approach to funding bioresources. There was also some support for our proposed design, such as measures to manage volume risk, including growth enhancement expenditure in our

[46] Also known as a 'gate fee'. Gate fees are the charges for providing a range of waste treatment, recovery and disposal services. For other organic waste it is commonly expressed on a per tonne basis.

econometric cost benchmarking models and auxiliary measures to support a move away from a building-blocks approach based on RCV.

Key concerns with our proposals were as follows.

- Setting a separate efficiency challenge for bioresources (and network plus) could lead to an inappropriately high overall cost challenge.
- There are issues with moving away from a building blocks approach based on RCV. Some stakeholders saw our proposals as i) complex and needing further development; ii) increasing the risk to companies through greater cost risk, asset stranding and volume risk, iii) potentially deterring efficient investment as regulatory protection for efficient capital expenditure would be lower during a period of regulatory uncertainty regarding future environmental regulation; and iv) providing insufficient regulatory protection for pre-2020 RCV-related costs.

We also received feedback on the potential data we could use and the example model result set out in our supplement document.[47] In general, companies agreed with us that there are issues with the data and models required to implement a move away from a building-blocks approach based on RCV which would require further work to resolve.

3.7.3 Key changes from our draft methodology

Moving to a more market-based approach to funding bioresources, where appropriate, is in customers' interests. Promoting the role of markets in relation to bioresources activities will help the sector to meet its potential to create economic and environmental value by enabling and incentivising technological changes, economies of scale, inter-company optimisation and co-digestion of sludge with other organic waste.

We will partially reform how we fund bioresources at PR24 and intend to move to a fully reformed approach at PR29. This will give the sector time to develop better data and to adjust to the new proposals. We note that our approach will help to address many of the concerns raised by stakeholders.

3.7.4 Our final methodology for bioresources controls

At PR24, as at PR19, we will set revenue controls for the bioresources activities of English and Welsh wastewater companies to protect the interests of customers as they cannot choose an alternative provider for this service. Our approach to regulating companies at PR24 will provide further support for the market as follows.

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[47] Ofwat, 'Bioresources control: supplementary document', September 2022.

We will set an average revenue control based on the amount of sludge companies produce. This approach will make sure that companies' revenue is linked to how much sludge they need to transport, treat and dispose of. An average revenue control comes closer to a 'gate price' type of approach which is how waste is frequently charged for in the wider waste sector.[48] This is different to the 'modified average revenue' control we used at PR19 where much of companies' allowed revenue was fixed.

We will assess companies' costs in a more market-based way. We will assess a greater proportion of companies' costs through a single benchmarking approach and set a separate efficiency assessment for bioresources activities. We will include growth enhancement costs in our econometric models. This will come closer to how a market operates where competitors' costs are compared with each other by potential customers. Our approach to assessing companies' costs is set out in Chapter 6.

We will set a separate efficiency challenge for bioresources (and wastewater network-plus) to drive further efficiency. A separate efficiency assessment will be more transparent and more likely to achieve a stretching, targeted efficiency challenge for bioresources activities.

There will be no cost sharing for bioresources. This is consistent with the approach to the bioresources price control in PR19. In addition, we will not apply business rates cost sharing for bioresources in PR24.

We will set an end-of-period reconciliation to:

- correct for any over- or under-recovery of revenue over the 2025-30 period - this will provide an effective mechanism to incentivise companies to collect an appropriate amount of revenue and address any imbalances in a timely way; and
- incentivise accurate sludge production forecasts over the 2025-30 period – sludge production forecasts are needed to set an accurate average revenue control.

We expect companies to take a leadership role in developing the bioresources market and to fully exploit the opportunities it creates. We expect companies' business plans to set out:

- **a sludge strategy** – as part of this, companies should set out the steps they have already taken and are planning to take to address the expectations we set out in our bioresources market review regarding greater sector collaboration where appropriate (and mindful of competition law considerations);[49]

[48] Please note that RAG 5.07 contains relevant guidance on setting transfer prices for bioresources. Our form of control at PR24 does not replace this.
[49] Ofwat, 'Review of the bioresources market – consultation', May 2021. See p. 23 onwards. We set out expectations on sewerage companies to work with each other and the rest of the sector to address many of the issues identified in Jacobs' report. For example, regarding forming regional partnerships; research that could be best undertaken at sectoral level; and the development of sector level measures for sludge quality. We also set an expectation that

- **stretching cost forecasts** – this should take account of market opportunities and use appropriate benchmarks to demonstrate value for money; and
- **accurate sludge production forecasts** – companies should now be accurately measuring their sludge production and this should be appropriately reflected in production forecasts. Companies should set out how they have made sure of the accuracy of their sludge production figures and how any steps they have taken to improve this have impacted their reporting of sludge production.

We plan to move to a fully reformed approach at PR29. We plan to make further changes at that time, such as including financing costs in our cost econometric benchmarking models and providing an annualised allowance for quality enhancement costs over one regulatory period only.

Further details of our proposals relating to bioresources are set out in Appendix 4 – Bioresources control.

3.8 Direct procurement for customers

3.8.1 Summary

DPC is a process whereby companies put major projects out to competitive tender for delivery by third parties. Competition for delivery provides good value for customers by driving down costs, while maintaining quality. The successful bidders for DPC projects, known as the Competitively Appointed Providers (CAPs), will be responsible for designing, building, financing, and potentially operating and/or maintaining the infrastructure.

For PR24, DPC will apply by default for all discrete projects over £200m of whole life totex. We will also:

- publish updated technical guidance in early 2023 defining a discrete project that is suitable for delivery by DPC;
- implement a focused incentive package so that DPC schemes are delivered well; and
- amend the licences of those companies likely to deliver DPC projects in the 2025-30 period if they do not already have DPC provisions in their licences.

3.8.2 Responses to our draft methodology

Respondents generally supported the use of DPC where it is demonstrably in the best interests of customers. Stakeholders welcomed the increase in the size threshold from

companies consider other areas for working collaboratively, such as providing any extra market information in a standardised way and agreeing common processes or standards.

£100m to £200m whole life totex, with some suggesting it should be increased further. Stakeholders queried the use of DPC for projects below the size threshold.

A range of more detailed points were raised, including:

- the treatment of negative value for money assessments;
- use of the Specified Infrastructure Projects Regulations (SIPR) regime as an alternative to DPC for very large projects;[50] and
- allowing companies to bid to deliver their own projects.

3.8.3 Key changes from our draft methodology

Having considered stakeholder responses, our policy positions remain as stated in the draft methodology. It is important that DPC delivers best value for customers. We have considered the size threshold and continue to think this is appropriate based on the evidence we have seen. In line with Condition U of companies' licences (DPC), we will only consent to a project being put out to tender under DPC if it is likely to provide value for money. In response to some queries, we confirm that companies do not need to assess the suitability of DPC for projects below the size threshold as part of their business plans. We also remain open to companies exploring the use of SIPR where it may offer benefits to do so. Respondents' views are discussed in more detail in Appendix 5 – Direct procurement for customers.

3.8.4 Our final methodology for Direct Procurement for Customers

In PR24 business plans DPC will apply by default for all discrete projects over £200m of whole life totex.[51] This applies to all parts of the water and wastewater value chain, apart from bioresources. Companies are not required to assess the suitability of DPC for projects below £200m, but we reserve the right to explore this – for example, for major projects which pose delivery or financeability challenges because they are large compared with the size of the company.

Above the threshold, companies must assess the extent to which schemes are discrete using our technical guidance and support this assessment with evidence. We are in the process of reviewing our technical guidance and will publish the revised guidance in early 2023.

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[50] The SIPR regime is established under the Water Industry (Specified Infrastructure Projects) (English Undertakers) Regulations 2013 (SI 2013/1582).

[51] At PR19 we used a size threshold of £100m whole life totex. Companies may elect to use DPC below the revised £200m threshold at PR24 at their discretion. However, there may be lower net benefits for smaller schemes and we consider there is likely to be greater market appetite for schemes above the threshold.

As part of their business plans, companies should present a robust value for money assessment of project delivery through DPC for all eligible schemes.[52] Where we consider a negative estimate of value for money is not robust, we may require the company to proceed with DPC until an accurate estimate can be determined. Where a company considers delivery under SIPR is appropriate and could offer best value for money, they should set this out in a full assessment against the requirements set out in the legislation using our guidance.[53] Where there is robust evidence that use of DPC or SIPR would not deliver value for customers, a company should propose the project as part of enhancement expenditure in its business plan.

Where schemes are delivered via DPC we will allow funding for pre-construction activities, running the procurement process for DPC (or SIPR where relevant) and managing the CAP. In line with our current DPC framework, the costs of the CAP will be recovered from customers outside the price controls in accordance with an Allowed Revenue Direction. As a consequence, we will not include funding for in-house delivery of DPC schemes when we set price controls.

As part of our quality assessment of business plans, we will assess whether companies propose the use of DPC for all eligible schemes, in line with our 'DPC by default' approach. Further details are set out in Chapter 11.

Through PR24 and the Allowed Revenue Direction, we plan to implement a focused package of DPC incentives for companies. The appropriate incentive package will be decided on a project-by-project basis recognising the risks inherent in the project and the potential value obtainable from the procurement process. We are currently consulting on the suite of incentives that we will consider when agreeing the incentive package for a DPC project.[54]

As part of our draft DPC we have reviewed the existing provisions and proposed some minor changes to make sure that they are still fit-for-purpose. We plan to extend these provisions to the licences of companies likely to deliver DPC schemes in the 2025-30 period if they do not already have DPC provisions in their licences.

More detail on our approach to DPC at PR24 is provided in Appendix 5 - Direct procurement for customers.

[52] Eligible schemes are discrete projects above a size threshold of £200m whole life totex where DPC will apply by default.
[53] Ofwat, 'Criteria for selecting specified infrastructure projects – Ofwat guidance', May 2015
[54] Ofwat, 'Draft Guidance for Appointees delivering DPC projects', September 2022, pp. 36-37.

4. Reflecting an understanding of customers and communities

4.1 Introduction and summary

Business plans and long-term delivery strategies should be informed by high-quality research and engagement evidence. At PR24, we are asking water companies to explain how they will deliver the right outcomes, at the right time, to help meet long-term objectives for water customers, communities and the environment – including how companies will support affordability issues for current and future customers.[55]

This chapter sets out our expectations of companies in relation to customer and wider stakeholder engagement. These expectations are set in accordance with our duties and expectations set out in the UK and Welsh Government strategic policy statements for Ofwat.[56]

4.1.1 Key messages

We expect companies' price review submissions to recognise and address the needs and priorities of **current and future customers**. In addition, we expect companies to ensure that their submissions set out how they will support those who struggle to pay their water bills.[57]

- It is vital that companies understand the **diversity of customers' and communities' needs, priorities and concerns** so that their PR24 business plan proposals and long-term delivery strategies target the right outcomes at the right time.
- Engagement with customers and wider stakeholders should provide information about views on the affordability of their plans and should focus on aspects of plans where customer views can have a **meaningful influence**.[58]
- Working with companies and CCW we have **implemented a collaborative approach to some customer research for PR24**.[59] [60]
- We expect each company to undertake further engagement with customers to inform company-specific parts of business plans. This should ensure that the manner of fulfilling statutory requirements and **locally important priorities and the phasing of delivery**

[55] Appendix 1 - Affordability sets out our expectations of companies' approach to affordability for all customers, and in particular for those customers who are struggling to pay their bills.
[56] Including having due regard to our Public Sector Equality Duty (see section 149 of the Equality Act 2010).
[57] See Appendix 1 - Affordability.
[58] CCW report by Blue Marble, 'Engaging water customers for better consumer and business outcomes', May 2020.
[59] We are involving wider English and Welsh stakeholders, such as Defra, Environment Agency, Welsh Government and Natural Resources Wales via the governance arrangements for the collaborative research. See Appendix 1 of 'Collaborative customer research for PR24' for the terms of reference for the steering group(s).

of targeted outcomes are informed by customers', community and wider stakeholders' views.

- Companies should be able to demonstrate they have met the **standards** we have set for high-quality research, customer challenge and assurance of customer engagement.[61]
- We require companies to hold two **Your Water, Your Say / Eich Dŵr, Eich Llais sessions** (called open challenge sessions in the draft methodology), which customers and other stakeholders can attend so that they have opportunities to challenge companies on their plans directly in an open forum.

Sections 4.3 to 4.6 of this chapter and Appendix 6 – Your Water, Your Say provide more detail on each of the above areas.

4.2 Responses to our draft methodology

In general, companies and wider stakeholders expressed support for our approach to reflecting an understanding of customers and communities, including our proposals for open challenge sessions. We explain how we have considered stakeholder views under the relevant heading in the following sections of this chapter.

Company and wider stakeholder respondents to the draft methodology suggested that we clarify our definition of customers so that we are explicit about:

- inclusion of business customers;
- requiring companies to understand the perspective of business retailers; and
- inclusion of organisations in the supply chain.

Some non-company respondents commented on the importance of water companies influencing consumer behaviour and the role water companies have to play in educating customers on water use.

Company respondents to the draft methodology made observations about the collaborative approach to customer research for PR24. This included points made previously in response to prior consultations. For example, about the methodology for ODI rates research, they raised again concerns about us setting ODI rates based on a single piece of customer research. Companies also commented on the potential for centralised research to limit the scope for customers to influence plans, and the potential for the timing of the collaborative research projects, such as fieldwork results, being influenced by external factors at the time of the research, or the research findings being too late for company use.

Respondents to our draft methodology consultation broadly agreed with the introduction of open challenge sessions, although company responses were mixed.

[61] Ofwat, 'PR24 and beyond: Customer engagement policy – a position paper', February 2022.

Company respondents queried the relative importance of, and weight being placed on, company-specific customer research, the evidence from the collaborative research projects and messages from open challenge sessions. Some companies argued that the proposed open events may not add value over and above existing customer challenge arrangements and customer engagement activities. Many companies asked for more detail about the proposed open challenge sessions and encouraged us and CCW to engage with the water companies as we develop our plans for the sessions. Other respondents commented on the need for an inclusive approach to open challenge sessions, and pointed out the risk of a single issue dominating discussion.

4.2.1 Key changes from our draft methodology

This chapter provides up to date information on our plans for Your Water, Your Say / Eich Dŵr, Eich Llais sessions and we have a new appendix to this document setting out additional detail.[62]

Having considered stakeholder responses, our policy positions remain as stated in the draft methodology.

4.3 Customers are central to PR24

Our price reviews must be conducted in the interests of consumers: we expect companies to demonstrate that they put the interests of current and future customers at the heart of the way that they run their businesses, which includes their plans for PR24 and beyond.

At PR24, we expect companies' plans to reflect the need for greater investment so that their plans address the key challenges we set out in Chapter 2:

- meeting rising expectations about what water companies need to deliver for their customers and communities;
- protecting and enhancing our environment;
- adapting to climate change and meeting net zero emissions; and
- delivering affordable bills, in the context of increasing cost of living challenges.

We expect companies to provide support for those who struggle, or are at risk of struggling, to pay their water bills.[63] We also expect companies to consult and take effective action to identify and support customers in vulnerable circumstances, including those who are only vulnerable for a short time.[64]

[62] See Appendix 6 – Your Water, Your Say.
[63] See Appendix 1 – Affordability.
[64] See Appendix 1 – Affordability.

For the purposes of the price review, 'customers' are the end users of water and wastewater services.[65] [66] In response to company and stakeholders' suggestions made in responses to our draft methodology, we confirm our expectation that **companies are engaging with the full diversity of needs and priorities of the customers that it serves and also wider stakeholders**.[67] This should include:

- household and non-household customers;
- business retailers;
- developers;
- new appointees and organisations in the supply chain for the water sector; and
- future customers.[68]

Companies need to engage effectively with their customers and wider stakeholders to inform their PR24 business plans and long-term delivery strategies. Effective partnerships between companies and their customers, communities and stakeholders are also vital to addressing urgent challenges such as reducing sewer blockages, reducing sewage discharges and identifying (then delivering) nature-based solutions. Effective engagement between companies and customers and other stakeholders is also important to achieving long-term aspirations, such as changing water-usage habits. This means involving customers in service design and delivery, providing education and sharing information to support their meaningful and active engagement.[69]

4.4 Meaningful understanding of customers and communities

Companies' engagement with customers and wider stakeholders should focus on aspects of plans where **customer views can have a meaningful influence and make sure that customers can be involved in a meaningful way**.[70]

At PR19, we found that companies had engaged with more customers than ever before, with many companies demonstrating high-quality and innovative approaches. However, we found the results from companies' research varied significantly on common issues, with no clear

[65] 'End users' are residential and business users of water and wastewater services. Customers of eligible business premises in England and, to a more limited extent in Wales, can choose their Retailer; where this is the case, in general, these retail services are subject to separate regulatory arrangements under the business retail market and are not covered by the price review. Wholesale services are provided by the incumbent water companies. The provision of wholesale services (~90% of the final customer bill) and retail services which are not covered by the business retail market are covered by the price review to ensure business customers' interests are protected. For example, many of the common performance commitments (PCs) apply to the provision of wholesale services irrespective of whether the end customer is a residential or business user. We are introducing a new common PC in England (BR-MeX) capturing other aspects of wholesale services provided to business customers.
[66] Ofwat, 'PR24 and beyond: Customer engagement policy - a position paper', February 2022, p. 17.
[67] Ofwat, 'PR24 and beyond: Customer engagement policy - a position paper', February 2022, p. 6 and p. 17.
[68] Ofwat, 'PR24 and beyond: Customer engagement policy - a position paper', February 2022, p. 10 and Appendix 2, pp. 16-17.
[69] Ofwat, 'PR24 and beyond: Customer engagement policy - a position paper', February 2022, p. 17.
[70] CCW report by Blue Marble, 'Engaging water customers for better consumer and business outcomes', May 2020.

underlying reason for the differences. We also found problems with the quality of research approaches in some instances, meaning that we could not rely on the evidence. Examples included insufficient sample sizes, insufficient engagement with the full diversity of customers and not providing comparative information about current company performance.[71]

We have developed our customer engagement policy for PR24 to address the issues we experienced at PR19, which limited our ability to take account of customer evidence submitted by companies in support of their business plan proposals.[72]

4.4.1 Some customer research is being done collaboratively

Working with companies and CCW, we have implemented a **collaborative approach** to customer research for certain aspects of PR24.[73] This approach is being used in specific areas of research to inform common areas of business plans. We are taking account of differences between the English and Welsh contexts, as appropriate.[74]

A consistent approach to research is important where our assessment of business plans is better if we can compare results across all companies. We expect companies to take account of the results of the collaborative research as they build their PR24 business plans and long-term delivery strategies.

Many companies' and wider stakeholders' responses to our draft methodology consultation expressed support for the collaborative approach to customer research for PR24. They acknowledged the benefits of collaboration as well as the importance of meaningful customer research and comparability of research findings across companies. A small number of companies disagreed with our proposed approach to collaborative customer research projects. Their objections included:

- each company is best placed to engage with its customers and should own the relationship with customers;
- the standardised approach to customer research from Ofwat limits the scope for customers to influence plans;

[71] Ofwat, 'PR24 and beyond: Our reflections on lessons learnt from PR19', December 2020, section 5.1.2, pp. 48-49. and Ofwat, PR19 initial assessment of plans: Summary of test area assessment, section 4, pp. 26-34.
[72] Ofwat, 'Collaborative customer research for PR24', October 2021, set out the rationale for our plan to work with CCW and companies to do collaborative customer research which will generate robust results at company-level and allow us to reliably understand differences in views between customers of different companies.
[73] We are involving wider English and Welsh stakeholders, such as Defra, Environment Agency, Welsh Government and Natural Resources Wales via the governance arrangements for the collaborative research. See Appendix 1 of Ofwat, 'PR24 and beyond: Customer engagement policy - a position paper' for the terms of reference for the steering group(s).
[74] Note: the 'collaborative customer research for PR24' involves all companies across England and Wales. The 'collaborative approach in Wales', explained in Chapter 2, is the term used to describe the wider approach to involving Welsh stakeholders in the PR24 price review.

- the timing of the actual research may influence the results due to the prevailing context, such as heightened media attention on water companies, and the cost of living pressures; and
- the ODI rates research results and the methodology for generating ODI rates need to be shared early enough so that companies can use the same approach to develop ODI rates for bespoke PCs.

We have **continually and transparently engaged companies, wider stakeholders, and research experts** during the development and implementation of our collaborative research projects.[75] This includes consideration of a company-commissioned peer review of early ODI rates research proposals.[76] We are satisfied that each research project has adopted a robust methodology, leading to meaningful results.

In the following table, we explain the nature of each collaborative customer research project. The ODI rates research has involved a robust sample of each company's customer base, allowing us to generate company-level results. The guidance for affordability and acceptability research requires each company to adopt the standardised approach with its own customers, using actual business plan information and company data. When combined with high-quality company-specific research and other customer engagement activities we think that the collaborative approach to customer research is increasing the overall quality as well as comparability of customer research for PR24, which should result in customers' views being better reflected in companies' plans and our decisions.

We think that companies continue to have substantial opportunity to build relationships with their customers through ongoing engagement and consider it unlikely that our requirements for customer research would hinder in any meaningful way a company from building relationships with its customers.[77]

Consultation during development of the collaborative research projects has included consideration of the timing of the research being done. We acknowledge the need to consider the wider context in which customers' views were shared as we interpret the results of each research exercise. We have endeavoured to meet, as far as possible, the requirements that companies have set out in relation to the availability of the results of research projects and the methodology that will be used to generate ODI rates. We have kept water companies and other stakeholders informed via the steering group arrangements.

The following table sets out information on the customer research projects that have been developed within the collaborative approach.

[75] We publish documents related to the collaborative research projects and the steering group on our website.
[76] Ofwat, ODI rates research - eftec report themes, September 2022.
[77] Ofwat,PR24 and beyond: Creating tomorrow, together - Appendix – Reflecting customers' preferences, May 2021, p. 7.

Table 4.1: Research projects within the PR24 collaborative cross-sector customer research

Research subject[78]	Commentary
Customer priorities[79]	In a joint project with CCW, we conducted research, involving a representative group of customers across England and Wales, to understand what matters most to customers and why. We have used this research to inform the development of performance commitments for PR24. We are also considering aspects of it in other areas of the price review development, and our wider work, for example considering the outcomes that are most important to customers and our approach to affordability.
ODI rates research	Our webpage for the PR24 collaborative customer research provides additional detail about the ODI rates research methodology.[80] Working with CCW, and water companies, we conducted stated preference research with robust samples of each companies' customers leading to company-level results. We are using this research to inform setting of each company's ODI rates for some common performance commitments. Chapter 5 sets out that we plan to publish indicative ODI rates in early 2023. We expect companies to use the results of this research, as far as possible, to inform any proposals for the ODI rates related to bespoke performance commitments. We also expect companies to use the customer valuations derived from this research to inform their business cases for cost enhancement schemes. We believe this will ensure that companies use a robust and consistent approach to valuing the benefits of enhancement schemes.[81] Chapter 5 and Appendix 8 of this document set out our expectations for how companies will adopt the results of the ODI rates research.[82]
Affordability and acceptability	Working with CCW and water companies we have developed a standardised approach to customer research into the acceptability and affordability of each company's business plans and long-term delivery strategies ahead of their submission to us. We are issuing guidance for companies to follow.[83] The standardised research approach includes deliberative research to explore participants' views on the acceptability and affordability of water company's proposals for PR24 submissions, including their views on the phasing of outcome delivery over the longer term. Following the qualitative stage of research, a quantitative survey will further explore participants' views of the affordability of the company's proposals. We expect all companies to implement research in accordance with the guidance. The guidance sets out our expectations for how companies must demonstrate that the prescribed approach has been followed.

[78] We are publishing documents relating to the PR24 collaborative customer research approach on our website.
[79] Ofwat and CCW, 'Research on customer preferences: A joint report', April 2022.
[80] See ODI rates research table on our website.
[81] See Appendix 9 – Setting expenditure allowances.
[82] See Appendix 8 – Outcome Delivery Incentives.
[83] The guidance will be published on our website.

	We explain our expectations of companies in relation to addressing the overall affordability of their PR24 submissions and the provision of support to customers who are struggling to pay their bills in Appendix 1 - Affordability. Also, the Quality and ambition assessment chapter and appendix set out our minimum expectation that companies can demonstrate that they have followed the guidance for affordability and acceptability research.[84] CCW are planning to implement a comparable research approach for testing customers' views of our PR24 draft determinations. We will continue to work collaboratively with CCW during development of the research approach.

4.4.2 Some customer research is specific to each company

We expect companies to understand customers' views on the nature and phasing of delivery of statutory requirements for PR24 and beyond and other priorities that are identified through engagement with customers, communities and wider stakeholders.

We expect companies to conduct company-specific research, use customer data from day-to-day operations, or information from ongoing engagement activities to inform their proposals in a range of areas, including:

- company-specific outcomes involving enhancement schemes;[85]
- any bespoke performance commitments and related ODI rates;[86]
- long-term delivery strategies;[87]
- where companies seek to deliver wider environmental and social benefits beyond their minimum statutory requirements and at a greater cost to customers;[88]
- company specific adjustment to the allowed cost of debt (if applicable);[89] and
- development and introduction of new social tariffs. [90]

The related chapters/appendices of this PR24 final methodology explain the role of high-quality evidence of customer views within our assessment of proposals.

Some company respondents to our draft methodology consultation encouraged us to provide more information on the relative importance and weight that may be placed on company-specific customer research and the nature of our assessment of company-specific evidence of customer views. Evidence of customer engagement presented in support of company-specific proposals such as those listed above will be assessed against the standards for

[84] See Chapter 11 and Appendix 12 – Quality and ambition assessment.
[85] See Chapter 6 and Appendix 9 – Setting expenditure allowances.
[86] See Chapter 5 and Appendix 8 – Outcome delivery incentives.
[87] See Ofwat, 'PR24 and beyond: Final guidance on long-term delivery strategies,' April 2022.
[88] See Chapter 6 and Appendix 9 – Setting expenditure allowances.
[89] See Chapter 7.
[90] Ofwat, 'Social tariffs guidance', 2012.

customer research, customer challenge and assurance of customer engagement described in the next section. Where we are not satisfied that evidence of customers' views meets the standards set out, we may not give that evidence any weight in our assessment of company proposals.

Companies' approaches to customer engagement to support development of plans should allow data to be collected efficiently. It should complement, and not detract from, engagement with customers to make sure day-to-day decision making and delivery is continuously improving.

4.4.3 We expect companies to demonstrate they have met standards

We have published a position paper setting out **standards for research, challenge and assurance.**[91]

We have described standards that we expect companies to meet for:

- high-quality research;
- customer challenge on the nature, quality and use of customer engagement evidence; and
- assurance of the quality and use of customer engagement evidence.

We expect companies to provide evidence that these standards have been met for all engagement activities used to inform PR24 submissions, including but not limited to the areas of PR24 submissions mentioned in Section 4.4.2.

We are also making sure that the collaborative customer research projects mentioned above meet these standards by:

- our transparent and inclusive approach;[92]
- involvement of wider stakeholders and external research experts; and
- consideration of academic and other expert peer reviews of methodologies.

[91] Ofwat, 'PR24 and beyond: Customer engagement policy - a position paper', February 2022.
[92] We are publishing documents relating to the PR24 collaborative customer research approach on our website.

4.4.4 Hearing directly from customers and other stakeholders

The price review framework inevitably results in Ofwat hearing each of the water companies putting its case. We also hear from local and national stakeholders who advocate for outcomes for the environment or long-term government priorities to be delivered.[93]

We want our price review decisions to be more **transparently and directly informed by the views of customers and communities** so that we better understand:

- the key issues that companies should be taking into account as they develop their price review submissions, including affordability concerns; and
- whether the final business plan addresses customers' concerns and environmental priorities.

In our draft methodology we proposed **open challenge sessions**, which customers and other stakeholders can attend so that they have opportunities to challenge companies on their plans directly in an open forum.

Respondents to our draft methodology consultation broadly agreed with the introduction of open challenge sessions, although company responses were mixed. Company respondents made observations on a range of themes, including:

- purpose and weight on evidence from open challenge sessions compared to other evidence of customers' and stakeholders' views.
- potential to make use of existing mechanisms for customer and stakeholder challenge;
- timing of the open challenge sessions; and
- practical considerations.

We confirm that we expect each company to hold two open challenge sessions, now called **Your Water, Your Say / Eich Dŵr, Eich Llais**: one during development of the business plan; and one following the October 2023 submission for PR24.

We have provided an appendix to this document that provides a more detailed description of our expectations for Your Water, Your Say sessions, including our consideration of responses to our PR24 draft methodology consultation.[94]

As it is the statutory consumer body for the water industry in England and Wales, CCW agrees that it should have a key role. We are continuing to work together with CCW on development and implementation of Your Water, Your Say sessions.

[93] Examples for PR24 include WINEP, transition to net zero, and climate change.
[94] See Appendix 6 - Your Water, Your Say.

5. Delivering outcomes for customers

5.1 Introduction and summary

The outcomes framework holds water companies to account for the outcomes that customers pay for and incentivises companies to go further where it is in the interests of customers and the environment. We do this by defining performance commitments (PCs) which measure the level of service provided for a particular outcome. Common performance commitments are measured for all companies in England and/or Wales, while bespoke performance commitments are specific to individual companies.

We set the service standards we expect companies to deliver through performance commitment levels (PCLs). Outcome delivery incentives (ODIs) are the rates on which we base the underperformance payments for falling short of these service standards and the outperformance payments for exceeding them.

This chapter sets out:

- a summary of responses to our draft methodology, as well as key changes from our draft methodology (section 5.2);
- our approach to performance commitments (section 5.3);
- a summary of our approach to performance commitment levels (section 5.4 – with more detail in Chapter 6 and Appendix 9 – Setting expenditure allowances); and
- our approach to outcome delivery incentives (section 5.5).

We set out further information on topics covered in this chapter, including detailed consideration of responses to our draft methodology, in Appendix 7 – Performance commitments and Appendix 8 – Outcome delivery incentives.

5.1.1 Key messages

We want a simple and powerful outcomes framework that works alongside our wider regulatory tools to focus companies on delivering for customers, communities and the environment at PR24.

Our final methodology for the outcomes framework:

- **Sets performance commitments on key outcomes that are suitable for financial incentives** and are also **likely to be important in future price reviews**. This includes a strong focus on customer service, the environment and asset health performance – and measures to encourage improved outcomes for business customers.

- **Sits alongside our monitoring of further metrics outside of the price review**, including through our proposed integrated monitoring framework for operational resilience,[95] as well as metrics related to vulnerability and affordability. We will step in using our wider toolkit as appropriate.
- **Uses common performance commitments** for most areas of companies' performance to ensure robust performance commitment levels in areas important to all customers and a **small number of bespoke performance commitments**, for example to address issues of specific local importance or where a company is performing poorly in an aspect of service that is not a key concern for other companies.
- **Draws a clear link between our efficient expenditure allowances and the performance levels** that we expect companies to deliver and sets performance levels that reflect the need for companies to transform performance.
- **Provides powerful financial incentives on all performance commitments** – with a default of symmetrical outperformance and underperformance incentive rates based on the importance that customers place on each outcome.
- **Encourages innovation through enhanced incentives** for very high performance – available for all companies on well-established performance commitments.
- **Protects customers and companies from very high payments** through an aggregate sharing mechanism, by reducing payments beyond certain thresholds, supported by the targeted use of caps and collars on some performance commitments.
- **Signals that we expect revenue at risk to be equivalent to around a ±1% to ±3% return** on regulatory equity each year for an efficient company (not including the measures of experience).
- **Expects a step change in customer service and commits to reviewing and developing the measures of experience** (C-MeX, D-MeX and BR-MeX) through further engagement, taking account of our wider customer policy work and market developments, prior to our draft determinations.

5.2 Responses to our draft methodology

Stakeholders largely agreed on the scope and coverage of our proposed **performance commitments** for PR24, with CCW agreeing that it reflected the priorities of customers. Some stakeholders had detailed comments on our draft definitions, particularly for the new performance commitments. Some companies wanted us to allow more than 2-3 bespoke performance commitments to reflect local circumstances. For the customer measure of experience, we received a range of views on making it more representative and strengthening incentives.

Stakeholders broadly supported our proposed approach to **outcome delivery incentives**. Some stakeholders asked for more justification for setting relatively high standard incentive rates, or more guidance on how we will calibrate them during the determinations phase of PR24. Almost all companies supported us having enhanced incentives for key performance

[95] Ofwat, 'Operational resilience discussion paper', April 2022.

commitments, with suggestions for additional performance commitments that could qualify, although CCW expressed concerns with customers paying for very high performance levels.

We received a range of views on **managing outcomes risk**. While most stakeholders agreed that our performance commitments should incentivise improved outcomes for customers and the environment, including bearing some external risk, some companies said that we should automatically exclude the impacts of extreme weather events within our performance commitment definitions. Some companies also disagreed with removing caps and collars on well-established performance commitments, which limit financial payments beyond certain levels of performance, although many stakeholders supported moving towards aggregate sharing mechanisms. While CCW agreed with removing deadbands on statutory compliance performance commitments, almost all companies disagreed, arguing that this could lead to unacceptable levels of downside risk.

5.2.1 Key changes from our draft methodology

We have considered the feedback we received from stakeholders, including through subsequent engagement meetings and working groups. We provide detailed consideration of respondents' views and further analysis relating to our approach to performance commitments and outcome delivery incentives in Appendices 7 and 8 respectively.

Key changes compared to our draft methodology on **performance commitments** are:

- We will **apply performance commitments for serious pollution incidents and discharge permit compliance to all companies – including water-only companies**, which do not currently have these performance commitments.
- We will **set separate performance commitments relating to the different components of water demand** – leakage, per capita consumption and business demand (which will include the largest users of water).
- We have **refined our approach to measuring new environmental performance commitments** — river water quality, bathing water quality and biodiversity. This includes adapting the biodiversity performance commitment to make it applicable for use in Wales. We will align the operational greenhouse gas emissions performance commitment to the wider reporting on emissions that water companies provide in their Annual Performance Reports.

Key changes compared to our draft methodology on **outcome delivery incentives** are:

- Water companies need to deliver a step change in customer service and we will increase the size of C-MeX incentives in line with this. At present we expect C-MeX to account for **±18% of annual residential retail revenue**, but we will consider further following our review of C-MeX ahead of our draft determinations.

- **We will expand the scope of enhanced incentives**, which aim to encourage innovation and very high performance, to include the leakage and per capita consumption performance commitments.
- We will **introduce a deadband for the compliance risk index performance commitment**.
- While we will continue to manage outcomes risk primarily through the aggregate sharing mechanism, we will **extend our targeted use of caps and collars** to include performance commitments that have the potential to be a significant source of skew in the outcomes package, for example we expect to set a wide collar on the water supply interruptions.

5.3 Performance commitments

Figure 5.1 – Common performance commitments for PR24 (bold = new for PR24)

	Price control		
	Water and wastewater	Water only	Wastewater only
Customers receiving excellent service everyday	C-MeX (residential customer measure of experience) D-MeX (developer services measure of experience) **BR-MeX (business customer and retailer measure of experience) (England)** Business customer experience (Wales)	Water supply interruptions Compliance risk index (CRI) Customer contacts about water quality	Internal sewer flooding External sewer flooding
Environmental outcomes	**Biodiversity** Discharge permit compliance **Serious pollution incidents**	Leakage Per capita consumption (PCC) **Business demand** **Operational greenhouse gas emissions - water**	Total pollution incidents **Bathing water quality** **River water quality (phosphorus)** **Storm overflows** **Operational greenhouse gas emissions - wastewater**
Asset health		Mains repairs Unplanned outage	Sewer collapses

5.3.1 Overall approach to performance commitments

We want to focus performance commitments on the **key outcomes that are important for customers and the environment**, taking account of our statutory duties and the need to act in accordance with the priorities and expectations set out to us in the UK government's strategic priorities statement and the Welsh Government's strategic priorities and objectives.

We focus on outcomes that are suitable for **strong financial incentives**. We will minimise duplication between performance commitments and focus on outcomes not outputs. As set out in Appendix 9, where we cannot adequately capture the impact of enhancement expenditure through PR24 outcomes measures (for example because it addresses a low probability event or because the benefits will accrue beyond 2030), we will use **price control deliverables (PCDs)** to track delivery and return funding as appropriate.

Our outcomes regime will work alongside **wider tools outside of the price review,** including reputational incentives, licence conditions, charging rules and our enforcement powers. These tools are more suitable for some areas, where significant additional funding is not required, such as vulnerability and affordability, as they are more flexible and responsive. We will collect further information through our monitoring regime, including our proposed integrated monitoring framework for operational resilience,[96] to support these tools. Companies should also collect, develop and report further metrics for their internal decision making and to communicate with their customers and other stakeholders.

The key outcomes in PR24 are also **likely to be important in future** and we intend to incentivise them in future price control periods. Companies should therefore be clear that investments that improve these outcomes, and also failure to invest appropriately, will be recognised in future periods (see also sections 4 and 5 of Appendix 9).

The outcomes we specify relate to companies' functions and so they have significant control over these. External factors may also have an effect but, in many cases, companies can mitigate the impact of external factors, such as weather events, on customers. We want to incentivise companies to stretch their influence in this way when delivering their functions. **We therefore do not consider exclusions for such factors are appropriate**. We have allowed limited exclusions for external factors where companies cannot manage or mitigate potential impacts on customers and the environment or are outside of their statutory functions. In so doing, we have also taken account of how clearly the event can be excluded in practice including whether the exclusions would be proportionate or may compromise companies' focus on outcomes for customers, communities and the environment. In such cases, we specify this upfront in each performance commitment's definition. This is to provide clarity on what is expected from companies and to minimise examples of companies choosing to interpret and apply exclusions in different ways during the price control period. We discuss how we intend to mitigate overall financial risks on companies and customers in section 5.5.4.

Some performance commitments will be common across all companies within a nation. We refer to these as **common performance commitments**. In certain cases, such as biodiversity and business customer satisfaction, the definitions or guidance may differ between England and Wales. **Common performance commitments cover most areas of companies' performance** – although performance commitment levels and incentive rates may vary by company, including to take account of differences in policy and law between the UK and Welsh Governments. In some cases, a **small number of bespoke performance commitments,** which are tailored to an individual company, may be appropriate, for

[96] Ofwat, 'Operational resilience discussion paper', April 2022.

example to address an issue of specific local importance or because a company is performing poorly in an aspect of service that is not a key concern for other companies.

Overall, there will be **23 common performance commitments for each water and wastewater company in England and Wales and 15 common performance commitments for each water-only company**. These include a significant focus on the environment, as well as customer service and asset health and new measures to encourage better outcomes in the business retail market in England. Allowing for a small number of bespoke performance commitments, we expect around half the number of performance commitments compared to PR19.

5.3.2 Excellent service for customers every day

Performance commitments relating to customer service and operational performance will remain broadly the same as at PR19, including **water supply interruptions**, **internal sewer flooding** and **external sewer flooding**.

Companies will have **measures of experience for their residential customers (C-MeX) and developer services customers (D-MeX)**. Because these performance commitments have only been fully in operation for two years, we will continue to review their effectiveness alongside our wider tools to improve customer service. We will develop the detailed design of C-MeX and D-MeX, working with stakeholders, prior to our draft determinations.

English companies will have a new performance commitment that measures **business customer and retailer experience (BR-MeX)** to incentivise incumbent water companies (wholesalers) to take a more customer-orientated approach to resolving frictions in the business retail market and improve their performance. We will work with the market operator (MOSL) and other market participants to develop BR-MeX, based on feedback from business customers and retailers prior to our draft determinations. In light of stakeholder feedback, we will also explore whether key measures of wholesaler performance in the market (such as data quality) should contribute to a company's BR-MeX score.

We will continue to have a common performance commitment **for business customer experience for companies in Wales**, where the retail market is much more restricted, and will develop this further prior to our draft determinations.

5.3.3 Protecting and enhancing the environment

We are driving a step change in delivery for the environment through PR24. In developing performance commitments in this area, we have considered the specific circumstances of England and Wales. In Wales, this includes the Environment (Wales) Act 2016 and the Well-being of Future Generations (Wales) Act 2015. In England, this includes a new duty to secure a progressive reduction in the adverse impacts of discharges, the storm overflows discharge reduction plan[97] and environmental targets that the government may set in line with the Environment Act 2021.[98]

We are adding a range of environmental common performance commitments to those we used at PR19, in many cases standardising the definitions of bespoke performance commitments that cover these outcomes in the 2020-25 period. This includes performance commitments to **incentivise improvements in bathing water quality and reductions in operational greenhouse gas emissions**. The former is based on established regulations[99] and the latter will be based on the definition in companies' Annual Performance Reports.

In addition to existing performance commitments designed to **reduce leakage** and residential customer demand (**per capita consumption**) – we will have a new performance commitment for **business demand**. These measures will provide incentives for water companies to work to **reduce the amount of water taken from the environment.** In addition, our regulatory framework also pushes companies to invest in new water resources – see Appendix 9 - Setting expenditure allowances. Together these measures will ensure that the needs of water customers and the environment can be met in the longer term.

We are **introducing a common performance commitment for serious pollution incidents**, in addition to the existing total pollution incidents performance commitment. This reflects the increasing concerns of customers and other stakeholders over pollution incidents, enabling us to apply stronger underperformance payments for serious incidents. There has been a longstanding expectation that all companies should reach zero serious pollution incidents (category 1 and 2) as soon as possible. This has been reiterated in the UK government's SPS and is consistent with the Welsh Government's strategic priority for the environment. We will apply the serious pollution incidents and discharge permit compliance performance commitments to all companies, including water-only companies, expecting full compliance in the 2025-30 period.

We are **introducing new performance commitments for biodiversity, river water quality and to reduce the impact of storm overflows**. The biodiversity performance commitment will provide incentives to improve habitats including increasing the use of nature-based solutions and catchment management approaches. The river water quality performance commitment incentivises companies to reduce the amount of phosphorus discharged from their treatment works - including reductions delivered in partnership or through catchment-management approaches. Companies will also be incentivised to reduce the frequency of discharges of wastewater from their storm overflows (the number of spills). It will therefore help to incentivise companies to make quick and efficient progress towards UK government and Welsh Government ambitions.

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97 Defra, 'Storm Overflows Discharge Reduction Plan', August 2022.
98 Defra, 'Consultation on environmental targets', May 2022.
99 See the Bathing Water Regulations 2013.

There are some **differences in operating and legislative circumstances between England and Wales**. There are significant advantages to having common performance commitments across England and Wales to help benchmark and challenge companies, but we have reflected differences in the detailed guidance for the biodiversity PC. We will also reflect these differences in the performance commitment levels and incentive rates that we set for each company. We will also use other price control tools, such as PCDs, to ensure that we reflect specific circumstances in our determinations. We set out our expectations of where all companies should deliver the same performance commitment level and where levels may be company specific in Appendix 9 – Setting expenditure allowances.

We will also include any further performance commitments that are required to support a more outcomes-based approach to the Water Industry National Environment Programme (WINEP) and have worked with the Environment Agency to operationalise this approach.[100]

5.3.4 Maintaining and improving asset health

We will have the same asset health performance commitments as at PR19 – **mains repairs**, **unplanned outage** and **sewer collapses**.

Wider performance commitments, which measure direct impacts on customers and the environment can also provide insight about a company's asset health, such as leakage, pollution incidents, the compliance risk index and discharge permit compliance. We will also complement our asset health performance commitments with wider monitoring activities such as our proposed integrated monitoring framework for operational resilience.

5.3.5 Bespoke performance commitments

Bespoke performance commitments are appropriate where:

1. there are local circumstances that do not apply to most other companies and there is compelling evidence that a performance commitment is required to provide incentives to drive benefits for customers, communities and the environment; or
2. a company provides poor service on a common issue where other companies' performance is generally adequate and the risk of performance deteriorating is low – such a performance commitment is likely to have underperformance payments only.

We will also consider other cases where a company has compelling evidence that there are company-specific circumstances which mean a bespoke performance commitment will lead to significant additional benefits for customers and the environment that are unlikely to be

[100] This includes issuing a joint letter with the Environment Agency to all English companies in September 2022 inviting them to submit proposals alongside standard WINEP submissions. We discuss an outcomes based approach to WINEP further in Section 5 of Appendix 9 - Setting expenditure allowances.

realised without it. These circumstances could result from responding to strategic steers on long-term outcomes and priorities from the collaborative approach in Wales.

As with common performance commitments, bespoke performance commitments should be suitable for financial incentives.

We expect **at most two or three bespoke performance commitments per company at PR24**. In response to stakeholder comments, we clarify that this is not a hard limit if the above tests are satisfied. However, based on our experience from previous price controls, we would not expect this to be the case. Where possible, we intend to use standardised definitions.

Companies should provide any proposed definitions for bespoke performance commitments by 14 April 2023. This is to enable companies to take account of feedback on their draft definitions and include fully developed proposals for any bespoke performance commitments in their business plan submissions. The submission should include any evidence of the additional benefits to customers and the environment. The definition of the performance commitment should measure the level of service provided for the particular outcome and be clear, unambiguous, complete and as concise as possible. Companies should demonstrate that the scope of the definition will help to provide appropriate incentives to deliver for customers, communities and/or the environment. We intend to provide feedback on draft bespoke performance commitment definitions in July 2023. Companies should take this into account in their business plan submissions. We will not provide feedback on performance commitment levels or ODI rates.

5.4 Performance commitment levels

We expect companies to submit business plans that will efficiently deliver a transformation in performance and meet the long-term requirements of customers, communities, and the environment in line with their legal duties.

At PR24 we intend to draw a **clear link between efficient cost allowances and the performance levels** we expect companies to deliver. This should drive greater service improvements for customers and the environment by reducing the risk that performance commitment levels for each company are set too low or too high.

We set out our approach for setting performance commitment levels for PR24, including how we have considered stakeholders' responses, in chapter 6.

5.5 Outcome delivery incentives

ODIs align the interests of companies and their investors with the interests of customers and the environment by directly linking performance with expected financial returns.

5.5.1 Setting standard incentive rates

All performance commitments will have both financial underperformance and outperformance payments by default. The only performance commitments that will not have outperformance payments will be where it is not possible, such as for statutory compliance performance commitments, or where a bespoke performance commitment is needed to address poor performance in an area.

We want these payments to provide powerful incentives on companies to focus on performance, taking account of the value to customers of each aspect of service. We also want to set rates in a consistent way between companies, while allowing for material differences in customer preferences.

Outperformance and underperformance rates will be symmetrical. We will set standard rates by applying a benefit sharing factor (X%) to the estimate of marginal benefits (MB) to a company's customers of a particular outcome, so that:

$$Standard\ ODI\ rates = MB * X\%$$

We generally expect to set the benefit sharing factor at 70% for all companies. We will calibrate final rates for each performance commitment during the determinations phase of PR24, based on considerations such as:

- the degree of confidence in the estimates of marginal benefits;
- wider benefits or strategic priorities;
- information on marginal costs; and
- our approach to cost sharing rates.

Companies will be able to provide their view of the benefit sharing factor for each performance commitment in their business plans.

For the **measures of experience (C-MeX, D-MeX and BR-MeX)** we expect to base the maximum outperformance and underperformance payments available on a proportion of relevant revenue, as we did at PR19. For the final methodology, we will increase the size of C-MeX incentives. At present, we expect this to increase **from ±12% to ±18% of annual allowed residential retail revenue**. We will consult further and review the design and incentive sizes of these measures prior to our draft determinations.

5.5.2 Valuing marginal benefits

The **collaborative customer research** (see chapter 4) will be the **basis for the marginal benefit estimates for the majority of common performance commitments**, except for biodiversity, operational greenhouse gas emissions and the measures of experience performance commitments. For the biodiversity and operational greenhouse gas emissions performance commitments, we will use credible external valuations.

We shared the initial results of the collaborative customer research with the collaborative customer research steering group, which includes water companies and customer representatives, in November 2022. We have been working with stakeholders to map these valuations to the definition of each performance commitment and will produce indicative rates in early 2023.

When estimating **marginal benefits for bespoke performance commitments**, companies should conduct research that is broadly consistent in approach to the collaborative customer research for common performance commitments and in line with the results where appropriate. This could be in collaboration with other companies and stakeholders. We expect companies to achieve the standards for conducting high-quality research set out in our PR24 customer engagement policy.

5.5.3 Enhanced incentives

Enhanced ODIs are designed to encourage companies to innovate to deliver major performance improvements. They can enable us to set more stretching performance commitment levels in future price reviews, benefiting the customers of all companies. For PR24, we will apply **enhanced incentives to all companies for selected common performance commitments**.

Enhanced incentives will be outperformance only, to incentivise outperformance that will have sector-wide benefits, and we will set **enhanced thresholds and rates on a consistent and streamlined basis**. Enhanced thresholds will use each company's performance commitment level as a starting point. We will apply a common improvement factor to all companies with a cross-check against historical and forecast performance, long-term and statutory targets, to ensure it is sufficiently stretching, with the aim to only reward companies for performance that is delivered through genuine innovation.

Enhanced incentives will only apply to common performance commitments that meet the following criteria, which we have revised based on stakeholder feedback:

- **clear benefits** to customers and the environment from very high performance;
- **well-established performance commitments** that enable us to set robust enhanced thresholds;

- **enhanced performance is achievable for all efficient companies**, and we are able to take account of company-specific factors when setting enhanced thresholds, where appropriate; and
- **no perverse interactions** with the wider price review framework, such as increasing the risk that customers pay more than they should for improvements or discouraging companies making themselves accessible to their customers.

Taking into account stakeholders' views, and in line with our criteria and approach to enhanced thresholds, we currently expect to set enhanced incentives at PR24 for:

- water supply interruptions;
- leakage;
- per capita consumption;
- internal sewer flooding;
- external sewer flooding; and
- total pollution incidents.

As part of our determinations, we will review whether these performance commitments continue to meet our criteria.

We will set enhanced incentive rates at twice the size of standard rates. We will only set enhanced caps for leakage and per capita consumption, because there is a risk that they unduly dominate the outcomes package. For the other performance commitments with enhanced incentives, we will not set caps as there are clear benefits to customers and the environment from very high performance, with limited risk of them dominating the package. Payments from enhanced incentives will be included in the aggregate sharing mechanism.

We note that a company that achieves enhanced outperformance payments in PR24 is also likely to earn outperformance payments in the following period if it continues to outperform other companies, as we intend to maintain our approach to setting performance commitment levels using a sector benchmark at PR29 (see section 5.5.5).

To ensure the customers of all companies ultimately benefit from enhanced incentives, **companies that achieve enhanced performance will be required to share the knowledge behind their success**. We will claw back payments if we consider a company's knowledge sharing activities are inadequate.

5.5.4 Managing outcomes risk

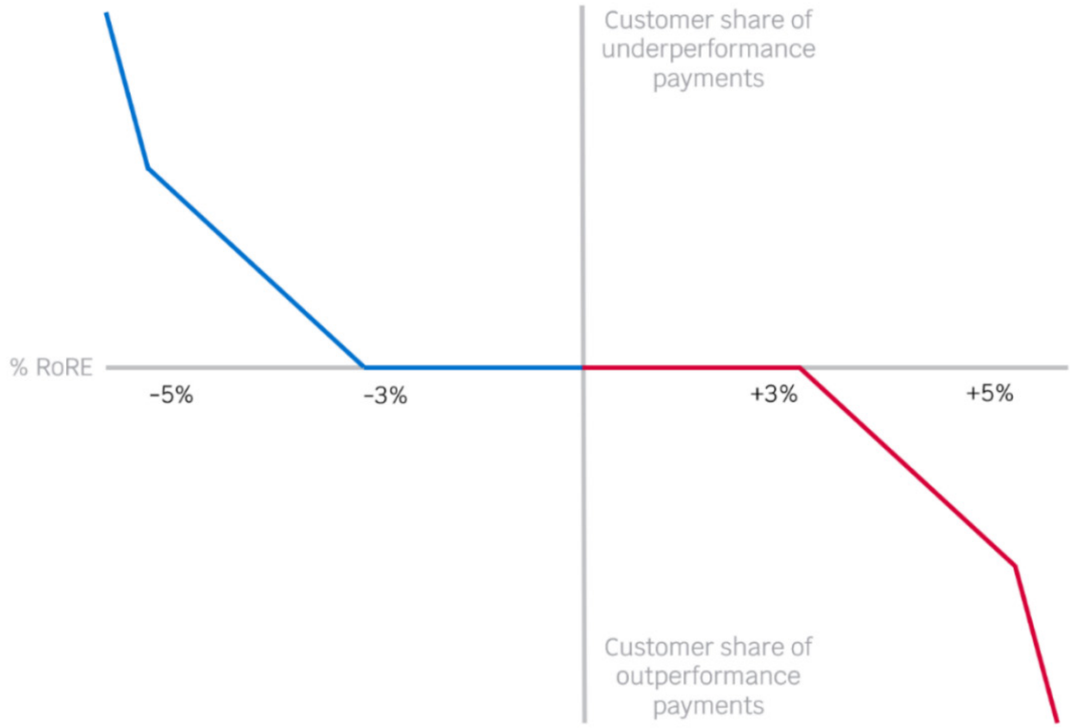
ODIs encourage companies to manage their own performance but also to assess and manage external risks that affect service. We want to ensure that companies are strongly incentivised to do this and are not disproportionately exposed to financial risk. We also need to protect customers from outperformance payments that are higher than expected.

We expect **revenues at risk from ODIs to be equivalent to around a ±1 to ±3% return on regulatory equity** (RoRE) each year. This excludes potential payments from the measures of experience performance commitments (C-MeX, D-MeX and BR-MeX). We will use a light-touch approach to estimating outcomes risk at PR24.

For PR24, we intend to manage ODI risk primarily at an aggregate level. We will use an **aggregate sharing mechanism that shares net ODI payments between customers and companies** once they reach certain thresholds each year. This reduces (but does not remove) the financial impacts of very high or very low performance.

We illustrate how this mechanism will work in Figure 5.2. As a starting point, companies can earn or incur up to +3% or -3% RoRE without any sharing of payments, beyond which payments are reduced by 50%. Beyond +5% and -5% RoRE, payments are instead reduced by 90%. We may adjust these thresholds to ensure the overall level and skew of risk is appropriate, informed by the latest performance data, companies' business plans and representations on our draft determinations. We will apply the aggregate sharing mechanism separately for payments relating to the wholesale water and wastewater controls, and not include C-MeX, D-MeX and BR-MeX payments.

Figure 5.2 – Illustrative aggregate sharing mechanism



In addition to aggregate protections, we can also manage risk exposure by using **caps and collars** on individual performance commitments, which limit the financial impacts of performance beyond a given threshold. We will only use caps and collars on a targeted basis to protect customers and companies from substantial risks in the outcomes package.

This includes performance commitments:

- that are **new or bespoke**, and therefore more uncertain;
- where the **benefits from high outperformance are uncertain**, to protect customers and avoid over-incentivising companies; or
- that have the potential to be a **significant source of skew** in the outcomes package.

In line with these principles, we expect to set caps and collars on all performance commitments that are new, bespoke or measure asset health. At this stage, we also expect to set a wide collar on the water supply interruptions performance commitment. We will determine the scope and level of targeted caps and collars during the PR24 determinations, taking into account the balance of risk. We will set the levels of caps and collars using a 'top-down' approach with reference to the expected RoRE.[101]

We will **not use deadbands for most performance commitments** because they substantially weaken incentives on companies for performance close to their performance commitment level. We will **only set a deadband on the compliance risk index performance commitment**, reflecting stakeholders' feedback, including from the Drinking Water Inspectorate, that it is challenging to achieve full compliance, particularly because performance against the measure can be affected by customers' internal pipes or fittings, responsibility for which is not within the statutory functions of water companies.

We will assess the overall balance of risk, and make any changes as necessary, such as adjusting the aggregate sharing thresholds and the scope of caps and collars.

5.5.5 Incentivising outcomes beyond PR24

We want to provide long-term certainty about the outcomes framework, so that companies invest and explore new ways to deliver performance improvements over multiple price reviews. We are **committed to maintaining the outcomes framework in future price reviews**. We expect the outcomes we are incentivising at PR24 to be of enduring importance to customers and the environment, and we expect them to be financially incentivised in future price review periods. We expect future performance commitment levels, which drive future ODI payments, to be set using a sector benchmark. This means top performers in the current period should expect to continue to earn outperformance payments in future periods if they maintain their relative performance (see chapter 6).

[101] The outcomes framework sits in the broader context of a company's statutory and licence requirements for service delivery. Independently of the outcomes framework, each company also has to ensure that it complies with its legal obligations, or risk enforcement action. If a company's performance falls below the level set for a performance commitment (irrespective of the existence of any deadband or collar), we will consider whether this is indicative of wider compliance issues to the detriment of consumers and whether enforcement action, with the potential for remedial and fining measures, is warranted.

For PR29, we **expect to maintain our broad approach to setting incentive rates**, such as using a bottom-up approach based on a share of marginal benefits.

5.5.6 Implementing payments

We expect to apply **all ODI payments annually** through in-period revenue adjustments. This will include relevant adjustments for inflation, taxation and the time value of money, broadly similar to our detailed approach at PR19.

We will only consider end-of-period payments for bespoke performance commitments where a company can demonstrate that the impacts on customers are expected to be realised over multiple price control periods and end of period assessment would not significantly reduce management focus on the relevant service areas or add disproportionate complexity.

Companies are able to **request to defer the impact of ODI payments between years** to mitigate extreme cashflow and bill volatility. We will continue to consider how we can **streamline the overall in-period determinations process**, taking account of further evidence during the 2020-25 period.

6. Setting expenditure allowances

6.1 Introduction and summary

This chapter sets out our expectations of companies for their expenditure proposals for PR24. To meet government, stakeholder and customer expectations, water companies will need to deliver significant improvements in performance over the 2025-30 period. To fund these improvements, we need to set appropriate expenditure allowances.

Water companies have historically spent around £10 billion per year in real terms. This directly impacts on customer bills. Setting efficient cost allowances helps to protect customers from paying more than they should for their water and wastewater services.

The way we set expenditure allowances and the expectations we place on companies on submitting expenditure proposals will be critical for water companies delivering additional value through PR24. It will directly contribute to the delivery of our goals of an increasing focus on the long term, delivery of greater environmental value and driving improvements through efficiency and innovation, as well as helping to deliver the needs of customers and communities.

Our aim is for customers to receive the levels of service they expect and are entitled to at an efficient cost and affordable price. Our final methodology builds on and takes account of responses to our draft methodology, as well as the May 2021 document,[102] assessing base costs at PR24 document,[103] responses to the Future Ideas Lab, [104] and discussions at the cost assessment working group.

Further information on topics covered in this chapter, including detailed consideration of responses to our draft methodology, are set out in Appendix 9: Setting expenditure allowances.[105]

6.1.1 Key messages

Water companies need to transform their performance to help rebuild trust and confidence in the sector. Our PR24 approach to setting expenditure allowances will support, encourage and require companies to step up to meet customer and stakeholder expectations, helping to enable companies to meet challenges now and into the future.

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[102] Ofwat, 'PR24 and beyond: Creating tomorrow, together', May 2021.
[103] Ofwat, 'Assessing base costs at PR24,' December 2021.
[104] Ofwat, 'Future Ideas lab', 2022.
[105] Ofwat, 'Creating tomorrow, together: Our methodology for PR24, Appendix 9: Setting expenditure allowances', December 2022.

- Companies will need to deliver a step change in efficiency. We will support this through our expenditure assessment with a greater focus on benchmarking and strong incentives for companies both to submit efficient business plans and to deliver those plans efficiently (see section 6.3).
- Companies need to deliver resilient services. Customers have funded and will continue to fund companies to be resilient. But customers should not pay again for past under delivery (see section 6.4).
- Companies need to deliver improved service to customers and the environment from expenditure allowances to keep water bills affordable. We expect companies to demonstrate that they are stretching themselves to deliver better service from existing allowances before we provide additional allowances (see section 6.5).
- Governments, regulators, customers, and other stakeholders have ambitions and expectations for the services that water companies provide. Companies will need to plan over the long term and use adaptive planning to identify what needs to be done in 2025-30, and what interventions should be scheduled in future periods where there will be greater certainty (see section 6.6)
- We expect companies to make fast progress towards government targets and deliver a transformative change in performance levels. The impact of storm overflows on our rivers is not acceptable. We expect all companies to reduce their use of storm overflows and, where appropriate, go beyond an annual average of 20 spills per overflow from 2025 onwards, without additional expenditure allowances. We will provide extra funding to reduce harm from storm overflows where government targets demonstrably go beyond current legal requirements. We are introducing a net zero challenge, providing extra allowances to companies that propose the most efficient and mature approaches to emission reduction. Companies should deliver national long-term leakage targets. And those with higher leakage levels should challenge themselves to go beyond these targets – or we will intervene to ensure they do so. (see section 6.6).
- Meeting government targets and regulatory and statutory requirements is likely to lead to a significant increase in enhancement expenditure. We expect companies to be ambitious in their business plans to help transform company performance and outcomes for customers and the environment. But customers should not pay for performance improvements that are not delivered. Companies are expected to develop price control deliverables (PCDs) for material investment that would not be adequately protected using PCs and ODIs. Companies that over promise and under deliver will be worse off as a result. (see section 6.6)
- Companies should deliver best value, so that they can deliver more for the funding that customers provide. This will require companies to take account of wider environmental and social benefits, costs, risks and affordability of customers' bills when developing their enhancement proposals (see section 6.7).

6.2 Responses to our draft methodology

Most responses to 'Chapter 6 – Setting expenditure allowances' of our PR24 draft methodology were from water companies, but we did receive responses on specific issues from other regulators, Consumer Council for Water (CCW), and some wider stakeholders.

Respondents broadly supported our proposed approach to setting efficient expenditure allowances at PR24, which built on our PR19 approach. Some respondents requested more detail on: (i) our proposed approach to assessing enhancement costs; and (ii) frontier shift efficiency and real price effects. Some respondents also expressed concern around the use of older historical outturn data to assess efficient base cost allowances.

Respondents mostly supported our view that resilience enhancement should be used to fund companies to manage increasing risks to specific hazards that are beyond company control and not covered by other expenditure allowances. Several companies reiterated their view that a step-change is needed in the level of asset maintenance and replacement at PR24.

Our proposed approach to setting performance commitment levels received a mixed response. Some respondents were supportive. But several respondents expressed concern that it would lead to unrealistic expectations of performance improvements deliverable from base expenditure. Respondents also reiterated the need to consider the role historical enhancement expenditure played in achieving existing performance levels.

Respondents supported the ambition of the proposed net zero challenge to allow additional net zero enhancement funding to drive down emissions but requested more clarity on how it would work in practice. Respondents also supported our proposals to incentivise companies to make rapid progress in addressing storm overflow spills and agreed that the cost of remaining compliant should be funded through base expenditure allowances.

Respondents mostly supported our proposed approach to encourage companies to deliver best value. Respondents also supported our proposal to remove the potential disadvantage nature-based solutions that are wholly or primarily funded with ongoing operating expenditure face compared to conventional capital expenditure solutions. However, there was a mixed response to how this disadvantage should be removed. Some respondents supported the two options we put forward (ie adding the whole life ongoing operating expenditure to the RCV and setting a ten-year ongoing operating cost allowance). Other respondents supported one of the two options, while others proposed a more complex multi-price control period funding solution.

6.2.1 Key changes from our draft methodology

Water companies have a duty to maintain an efficient and economical system of water supply, and to ensure that all necessary arrangements have been made for, among other things, maintaining and improving their water mains to ensure that they are able to meet their relevant water supply obligations.[106] At PR19, companies were funded based on plans to renew 0.4% of water mains per year. So far this period (2020-2022) they have only delivered 0.1% per year, which we are concerned is un-sustainably low and not enough to keep up with deterioration. Companies can submit cost adjustment claims to go beyond historical water main renewal rates where they can provide compelling evidence that an increase is required to maintain asset health. But water customers should not pay twice for the same mains renewals, and so we expect companies to undertake the renewals they were funded for before making additional allowances.

For third party services governed by the price control, we will include an end-of-period reconciliation to enable companies to recover their efficient costs if outturn activity is different to forecast.

We will publish historical performance data sets for PR24 performance commitments to support companies in determining performance improvements from base expenditure in early 2023. We will also collect and publish information on the influence of historical enhancement expenditure on historical performance.

We provide greater clarity on how we expect the transition to net zero greenhouse gas emissions to be funded and incentivised at PR24. We also provide further detail on how we will incentivise companies to reduce the number of spills from storm overflows.

6.3 A step change in efficiency is needed to allow the sector to do more

While the water sector showed relatively strong productivity post privatisation with growth of 3 to 4% per year between 1994 and 2000, it appears to have stagnated since 2011 with weak growth since then.[107,108] In PR19 we introduced measures to improve water sector productivity such as the £200 million innovation fund, a greater emphasis on markets, where appropriate, and incentives to deliver improved efficiency through cost sharing. We expect companies to use these measures to deliver a step change in efficiency both in their PR24 business plans and throughout the 2025-30 period. Only through this will the sector be able to deliver the improvements required by government and regulators in an affordable way.

We do not expect customers to pay for companies' inefficiencies. For PR24 we will continue to use a combination of catch-up efficiency, where less efficient companies catch-

[106] UK Government, Section 37, Water Industry Act 1991.
[107] Water UK study shows around 0% per year growth 2011 to 2017. Frontier economics for Water UK, Productivity improvement in the water and sewerage industry in England since privatisation, 2017, p. 3. Note this does not fully account for changes in quality.
[108] ONS multi-factor productivity data shows water sector productivity growth of -1.8% per year 2009 to 2021. This compares to an average of 1.1% per for manufacturing and 0.4% for the economy. ONS, Multi-factor productivity estimates, April 2022.

up with efficient companies, and frontier shift efficiency, where we expect even the most efficient companies to improve efficiency from improvements in working practices and the introduction of new technology. We will set catch-up efficiency based on our view of an appropriate efficiency benchmark.

For PR24 we will use the same overall approach to setting efficient expenditure allowances as PR19, and will use a combination of benchmarking models, cost adjustments and deep dive assessments, split across base and enhancement expenditure.

Base expenditure is routine, year-on-year expenditure, which companies incur in the normal running of their businesses to provide a base level of good service to customers and the environment. It includes expenditure to maintain the long-term capability of assets, as well as expenditure to improve efficiency.

It is important to recognise that companies are funded to be fully compliant with their current legal obligations through their base expenditure allowances. Any-non-compliance should be addressed by the companies, and we would not expect customers to pay for this.

To identify efficient base expenditure, we will use econometric benchmarking models, which use statistical methods to compare costs between companies on a like-for-like basis. These models consider multiple factors that drive differences in costs which are largely beyond a company's control such as company size, population density and treatment complexity.

For PR24 we intend to build on our PR19 benchmarking models. Given the broad support for the PR19 models, we have a high bar for changes.

For wholesale water and wastewater network plus base models, we are considering additional cost drivers based on company recommendations. Our wholesale water and wastewater network plus base cost efficiency benchmark could be more stretching than upper quartile. We will also consider using business plan forecast cost information to inform our efficient base expenditure allowances.

For our residential retail models, we will review how we model the impact of deprivation on companies' bad debt costs and explore alternative cost drivers proposed in responses to our draft methodology.

We intend to consult on our wholesale water and wastewater network plus base cost, residential retail cost, and bioresources econometric cost models in spring 2023. This will be informed by econometric cost models proposed by companies alongside our own independent model development. Companies can use these models to prepare cost adjustment claims ahead of an early cost adjustment claim publication in summer 2023.

Enhancement expenditure is generally where there is a permanent increase or step change in the current level of service to a new 'base' level and/or the provision to new customers of the current service. Enhancement funding can be for environmental improvements required to meet new legal obligations, improving service quality and resilience, and providing new solutions for water provision in drought conditions.

For all enhancement expenditure requests we will consider the need, optioneering, cost efficiency and customer protection evidence presented by companies. In PR19 for most enhancement expenditure we used unit cost and simple econometric models largely based on forecast data to set efficient expenditure allowances. We will build on this approach for PR24 and, where appropriate, will use historical and forecast expenditure to set efficient expenditure allowances. For the remaining expenditure where costs are material, we will use engineering deep dive assessments to identify an efficient cost allowance.

We expect companies to ensure that schemes are procured and delivered as efficiently as possible. As set out in chapter 3, we expect that companies use **direct procurement for customers** for all schemes above the £200 million threshold (see section 3.8).

Markets can drive innovation and efficiency for the benefit of customers and the environment. But we will continue to set revenue controls for the bioresources activities of English and Welsh wastewater companies at PR24 to protect the interests of customers as they cannot choose an alternative provider for this service. Our approach to regulating companies at PR24 will provide further support for the market. This is described in more detail in chapter 3 and Appendix 4 – Bioresources control.

Where possible, we will use **external benchmarks** to assess water sector efficiency. In PR19 we used external benchmarks to assess retail bad debt and customer service costs. We intend to use a wider set of external cost benchmarks for PR24 and take these into consideration when setting the efficiency challenge.

In an exceptional case, where a company considers that the benchmarking models do not fit its specific circumstances, it can submit a **cost adjustment claim** and provide evidence as to why it is different. Companies will need to provide compelling supporting evidence for any cost adjustments. We will continue to have a high evidential bar. For PR24 we are providing greater clarity on our expectations and placing a greater emphasis on two sided adjustments for factors reflected in historical expenditure.

Companies will need to submit stretching business plans in terms of efficiency. Companies that do not submit stretching business plans or submit poor quality cost adjustment claims will not receive the highest rewards for business plans.

Cost sharing is where over- and under-spending relative to cost allowances is shared between companies and customers. This incentivises companies to be efficient and shares risks with customers. We are proposing to simplify cost sharing rates for PR24 so that rates are more symmetrical, sharing cost risks between companies and their customers, and to have less variation in the rates between companies.

We will also consider the merit of setting lower enhancement cost sharing rates at PR24 draft and final determinations for areas where we are satisfied that the boundary between base and enhancement expenditure is sufficiently clear. Companies that submit the poorer quality business plans will receive the least favourable cost sharing rates and will bear more of the costs of underperformance. We will use the following rates across the four business plan assessment categories:[109]

- Outstanding - 50:50;
- Standard – 50:50;
- Lacking ambition – 55:45; and
- Inadequate – 60:40.

6.4 Companies will need to be resilient to deliver the required improvement in services

Resilience is the ability to cope with, and recover from, disruption and anticipate trends and variability, in order to maintain services for people and protect the natural environment now and in the future. Resilience is also a priority of both the UK government's SPS[110] and Welsh Government's SPS for Ofwat.[111] We expect companies to provide resilient services for customers today and over the long term.

Resilience has always been part of our regulation of the water sector. Water companies have a duty to maintain a water supply system and provide a wastewater system, so that they continue to meet their statutory security of supply and service obligations. These are legal obligations, which water companies must fulfil. Company business plans must reflect these obligations. Alongside our other statutory duties, we have a duty to act in the manner we consider that is best calculated to further the resilience objective.[112,113]

We expect companies to demonstrate adoption of best practice approaches to resilience and evidence best value in their PR24 business plans. Companies should have an integrated resilience framework in place following the PR19 requirement that they prepare resilience action plans to develop and implement systems based approaches to resilience in the round.[114] The integrated resilience framework should underpin the

[109] Throughout this section we refer to cost sharing rates in the following format (x:y) where 'x' captures the applicable cost sharing rate on overspend compared to PR24 cost allowances and 'y' captures the applicable cost sharing rate on underspend compared to PR24 cost allowances.
[110] Defra, 'The government's strategic priorities for Ofwat', February 2022.
[111] Welsh Government, 'Written Statement: Strategic Priorities and Objectives Statement for Ofwat (SPS)', July 2022.
[112] This is to secure the long-term resilience of water companies' water supply and wastewater systems and to secure that they take steps to enable them, in the long term, to meet the need the need for water supplies and wastewater services.
[113] The general statutory duties for most of our work as an economic regulator are set out in section 2 of the Water Industry Act 1991.
[114] Ofwat, 'Resilience in the Round - Ofwat', September 2017.

company's operations and investment plans, showing a line of sight between risks to resilience, planned mitigations, package of outcomes and corporate governance framework.

We fund companies to be resilient over the long term through a combination of base and enhancement expenditure. Both water resources management plans (WRMPs) and drainage and wastewater management plans (DWMPs) have resilience at their core and allow companies to identify enhancement investment required to maintain resilience over the long term, including combatting the impacts of climate change. In PR19 we set our base allowance using historical costs and used forecast cost drivers to account for future changes in the asset base. Historical allowances have been sufficient for companies to maintain and improve outcomes and asset health measures over previous periods.[115]

We are evolving our monitoring approach to provide a richer picture of operational resilience and improve our understanding of asset health. While the outcomes regime captures a company's failure to mitigate risks when they have an impact on service, it focuses on performance at a point in time. Therefore, it may not always provide the breadth and depth of information needed to gain insight into the effectiveness of a company's approach to maintaining assets or managing current and future risks. We are therefore developing an integrated monitoring framework to provide a more complete view of asset health and operational resilience. In our Operational resilience discussion paper we set out proposals to explore and test wider measures associated with the health and performance of water and wastewater assets.[116] This should better help us to understand operational resilience and asset health risks going forward

For PR24, we **aim to include more of a forward look in our base expenditure assessment**. We already include forecast cost drivers in our base cost models so that allowances reflect future changes in scale, density and complexity of water and wastewater treatment. We have collected additional data where treatment complexity might increase in the future so we can take this into account when setting efficient expenditure allowances. For example, due to phosphorous removal and ultraviolet treatment.[117] We will also consider whether we can take account of forecast expenditure data in our base expenditure models.

Companies address most of their resilience risks through base expenditure allowances, which has included the costs of addressing the historical impacts of climate change. We therefore expect companies to continue to undertake these activities. Companies have made improvements to asset health within base cost allowances in the past and we expect them to continue to do so in the future. We are open to considering company evidence on additional exogenous factors / cost drivers that require a step change in efficient capital maintenance expenditure through the cost adjustment claim process. Cost adjustment claims should not be used to make up for previous underinvestment or under delivery.

[115] Ofwat, 'Assessing base costs at PR24', December 2021, pp. 50-51.
[116] Ofwat, 'Operational resilience discussion paper', April 2022.
[117] Ofwat, 'IN 22/02 Cost assessment data requests', April 2022.

Companies state that they require a step change in expenditure on mains renewals. At PR19 companies were funded on the basis of plans to renew an average of 0.4% of water mains per year but have only delivered 0.1% per year for the period 2020-2022. We are concerned that current outturn rates are not sustainable and that companies are not undertaking enough renewals to keep up with deterioration.

Companies can submit cost adjustment claims to go beyond previous levels of mains renewals where they can evidence that an increase is required to maintain asset health. However, to ensure that customers do not pay twice for mains renewals previously funded we will take account of renewals companies have previously delivered when assessing claims.

At PR24 we will collect additional data on the condition of water distribution mains using the methodology adopted for PR04 and PR09.[118] We will use this data to assess the extent to which companies understand the state of their assets and as a check as to whether renewals are keeping pace with deterioration.

We will fund investment to improve resilience. Base expenditure allows companies to continue to deliver performance improvements in business planning and maintenance to improve resilience. Planning for, and delivery of, WRMPs and DWMPs will also make a significant contribution to enabling companies to be resilient. However, these do not cover managing increases in all hazards companies are exposed to. We have therefore amended the definition of the resilience enhancement line so that companies can request investment to manage increasing risks, or changing acceptance/acceptability of risk, from hazards that are beyond their control and not covered by other enhancement areas. We expect any such requests for investment to be set in the context of a long-term risk management plan, be supported by customers and be prioritised considering affordability. Where reducing system vulnerabilities addresses multiple hazards, within and beyond management control, costs should be proportionally allocated. We set out further guidance on our expectations for the evidence we expect to see to allow enhancement expenditure in Appendix 9: Setting expenditure allowances.

6.5 Companies need to deliver improved service to customers and the environment from expenditure allowances

Companies need to deliver a transformation in performance to ensure they can meet the long-term requirements of customers and the environment. There is increasing scrutiny from customers and stakeholders of companies' ability to deliver performance improvements. This is in the context of the environmental impact from pollution events, the impact of sewer flooding on customers, and the requirement to provide sufficient water supplies that meet drinking water quality standards.

[118] This broadly follows the grading methodology set out in UKWIR, 'Review of water mains serviceability indicators and condition grading: Volume II – mains condition grading,' 2006.

We expect companies to set out business plans that will efficiently deliver a transformation in performance and meet the long-term requirements of customers and the environment in line with their legal duties. **Companies should demonstrate ambition to deliver improving performance levels and affordable bills**. We specifically expect companies to challenge themselves to:

- propose stretching levels of performance from their base expenditure allowance; and
- ensure they maximise the benefits delivered by their statutory investment programmes across all areas of performance.

Performance commitment levels (PCLs) quantify the service levels companies are proposing to deliver for customers and the environment.[119] **We expect companies to identify stretching but achievable performance commitment levels (PCLs) in their business plans.** Companies should clearly articulate within their plans how they can efficiently deliver the transformation in performance necessary to ensure the sector is fit for the future.

When proposing PCLs within their business plans companies should reflect customer views and consider the expectations of other regulators. We expect companies to deliver improved performance through base expenditure allowances. But we recognise that companies will require enhancement expenditure to deliver part of their performance transformation. [120]

At PR24 we intend to draw a clearer link between cost allowances and the performance levels we expect companies to deliver. We will assess company proposals to ensure they are sufficiently stretching. We expect company proposals to build upon past successes and best practice. We will review historical outturn performance to establish the levels of improvement good performers have been able to deliver in the past.[121]

We have developed **several key principles for setting the PCLs an efficient company can deliver through our expenditure allowances**. We expand on four high-level principles in the paragraphs below and provide further detail in Appendix 9 - Setting expenditure allowances.

1. **We will consider if PCLs should be set on a common or company-specific basis**. Setting common PCLs aids comparison across companies, helping to set efficient and stretching performance, and makes expectations clear across the sector.

   We expect companies to deliver a **common level** of performance where we consider our efficient cost allowances should enable companies to deliver a comparable level of service to customers and the environment. Our base cost models include explanatory variables

[119] Further detail on the development of PR24 performance commitments and ODIs is included in Chapter 5.
[120] We discuss the expectations of the Environment Agency, Natural England, Natural Resources Wales and the Drinking Water Inspectorate further in section 6.6.
[121] To assist companies in their PR24 business planning we intend to publish in early 2023 the currently available historical performance trends we will consider alongside 2022-23 and 2023-24 outturn data when making our draft and final determinations.

that cover a range of exogenous factors that impact companies. Some companies therefore receive a higher expenditure allowance than others in part because of the additional challenges they face in delivering services to their customers.

We will consider setting **company-specific** performance commitment levels when there is compelling evidence that performance is materially affected by an exogenous factor not captured in our cost models and/or differences in historical enhancement expenditure allowances.[122]

2. **We expect efficient companies will continue to improve their performance over the long term from base expenditure**. Companies should challenge themselves to deliver more over time for customers and the environment through their base expenditure allowance. We expect efficient companies to deliver their PR19 PCLs on average and we will use these as the baseline for PR24 PCL setting.[123]

   Our analysis at PR19 demonstrated that cost-efficient companies were able to deliver performance improvements from base funding.[124] We have observed companies improving performance through a focus on, and management of, key performance areas. For example, we observe that industry average performance in both water supply interruptions and pollution incidents has improved by greater than 50% over the 2011-2022 period.[125] Customers should not have to provide additional funding to receive this improved service.

3. **We will consider the overall stretch across cost and service and account for the performance of efficient companies when setting PCLs**. We intend to review the level of performance expected to be delivered by companies across common performance commitments based on individual performance commitments and in-the-round. We will consider if PCLs are suitably stretching in the context of efficient expenditure allowances, historical performance, and the opportunity for companies to deliver improved performance.

   When setting an efficient rate of performance improvement, it is important to maintain the incentive for companies to outperform. In general, where we have confidence in an outturn performance dataset for a PC which demonstrates a spread of performance across the sector, we would not expect to use frontier performance to set PCLs. This

[122] See Appendix 6 for further details on proposed PCs.
[123] For performance commitments with PR19 PCLs. We will consider adjusting the baseline position in the case of material sector under or outperformance in PR19 PCLs resulting from factors outside of company control. For new PR24 performance commitments we will set a baseline based upon the available historical data and comparative company performance.
[124] Ofwat, 'PR19 final determinations – Overall stretch on costs, outcomes and cost of capital policy appendix', December 2019.
[125] Ofwat analysis based on the industry median, both performance commitments indicate a 53% improvement over the period. Pollution incidents have been normalised based on a constant sewer length (2018-19, aligned with current reporting) across the entire period. Hafren Dyfrdwy have been omitted from the pollution incident analysis due to no data being available for 2011-12.

allows better performing companies to retain outperformance benefits between investment periods, incentivising performance improvements over the long term.

4. **We will adjust PCLs to account for enhancement expenditure where necessary**. When setting a PCL for 2025-30 we will first consider the level of performance improvements expected to be delivered through base expenditure. We intend to request further data from companies to identify the degree to which current performance levels have been driven by enhancement expenditure. We will also assess business plan evidence and intervene to adjust PCLs to take account of future enhancement expenditure allowances where necessary. We expect companies' best value enhancement investment proposals to have a quantifiable impact on performance across a range of performance commitments.[126] We expect companies to identify and quantify these additional benefits in their PR24 business plans to enable us to account for them when setting PCLs. This protects customers from paying twice for the same performance improvements.

In alignment with these principles, we will set PCLs at PR24 for each PC by determining the level of performance we expect an efficient company to deliver. To do this we will consider:

- companies' baseline performance levels (ie 2024-25 starting point);
- the level of performance improvements deliverable from base expenditure, the impact of enhancement expenditure on performance (both historical and future);
- companies' forecast performance improvements;
- the opportunity for companies to deliver improved and transformed performance; and
- relevant statutory obligations and long-term performance targets.

We will intervene to adjust proposed performance levels for individual companies and across the sector where necessary. [127]

We expect companies to take account of our approach when developing their own long-term forecasts of the performance improvements they can deliver. These forecasts should inform companies' PR24 business plans and long-term delivery strategies.[128]

6.6 Facilitating efficient investment over 2025-2030 and the long term

This section outlines what we expect from companies at PR24 and how we are supporting and facilitating necessary investment and efficient delivery for the long term. This encompasses:

[126] We discuss our approach to assessing enhancement expenditure proposals in section 6.6 below and further in Appendix 9 - Setting expenditure allowances.
[127] In the case of national level targets, it may be necessary to adjust performance levels for multiple companies to reduce risk of non-delivery.
[128] Our draft business plan tables detail the forecasts we expect companies to submit.

- Planning needs and outcomes over the long-term;
- Delivering long term targets quickly and efficiently;
- Facilitating efficient long-term investment; and
- Delivering for customers and environment over the long term.

Planning investment and outcomes over the long term

Planning investment over the long-term is critical in ensuring that statutory requirements, government targets and customer needs are achieved in a sustainable and cost-effective way. To help facilitate long-term investment planning and outcome delivery we have introduced **long-term delivery strategies** which will be presented as part of companies' PR24 submissions.[129] We expect long-term delivery strategies to form a key part of the evidence to justify the need for enhancement expenditure in 2025-2030 and provide early sight of future investments.

Companies already have several long-term **strategic planning frameworks**. These frameworks include WRMPs, regional water resource plans and DWMPs. These frameworks are complemented by the water industry national environment programme (WINEP) in England and the national environment programme (NEP) in Wales. The outputs from strategic planning frameworks will need to inform, and align with, each company's long-term delivery strategy and business plan.

The Drinking Water Inspectorate has set out guidance for companies and other stakeholders with respect to long term planning for the quality of drinking water supplies. [130] We expect companies to clearly explain their PR24 investment proposals in the context of long-term plans aligned to long-term delivery strategies.

We have already set out our expectations for WRMPs and DWMPs.[131] These include our expectations that plans are adaptable,[132] optimised over the long term, consider a wide range of options, are best value and take account of customer and stakeholder views and partnership approaches. We continue to engage proactively in the development stages of these strategic planning frameworks. Companies will need to address our expectations and feedback in their final WRMPs, DWMPs and WINEP/NEP plans. We will take this into account, together with any differences between final plans and business plans, when we assess expenditure proposals and business plans.

The water industry strategic environmental requirements (WISER) from the Environment Agency and Natural England, and Natural Resources Wales's Expectations Document provide the frameworks for protecting and enhancing the environment in England and Wales.[133] [134]

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[129] See Chapter 10.
[130] DWI, 'Guidance Note: Long term planning for the quality of drinking water supplies', 2022.
[131] Ofwat, 'Ofwat's expectations for strategic planning frameworks at PR24', November 2021.'
[132] Ofwat, 'Final guidance on long term delivery strategies', April 2022.
[133] Defra, Water industry strategic environmental requirements (WISER), May 2022.
[134] Natural Resources Wales, 'NRW PR24 NEP expectations 2022' – draft issued July 2022.

Companies will need to deliver environmental schemes where they have a legal duty to do so, in a way which meets that duty, whilst also delivering best value for customers, and remaining affordable.

Environmental requirements set out in WISER and Natural Resources Wales's Expectations Document will be delivered through the WINEP and NEP processes. We are working closely with companies and environmental regulators during the WINEP/NEP development. We want companies to maximise the benefits that can be delivered across all their environmental programmes, with a focus on both outcomes that have statutory drivers and link to companies' core activities. Non-statutory improvements will need to be justified against our enhancement assessment criteria, including clear evidence of customer views on the proposed investment and outcome.

We support a move towards a more outcomes focused WINEP/NEP. This is consistent with the approach that we are taking for other enhancement expenditure. Under this approach we set the outcomes we expect companies to deliver and then the efficient totex allowances needed to support the delivery of these outcomes. We continue to collaborate with the Environment Agency to move to a more outcomes-based approach to WINEP and would support a similar approach in Wales. This includes giving English companies the option to submit proposals under the Advanced WINEP (A-WINEP) alongside standard WINEP submissions.[135] [136] A core aim of this work is to establish the management and governance frameworks necessary to operationalise an outcomes-based approach more widely in PR29 and beyond, in order to deliver better environmental outcomes.

Delivering long term-targets quickly and efficiently

Clear long-term targets set a firm direction for improvements. We set ODIs to incentivise companies to go beyond their PCLs where it is efficient for them to do so. However, there can be uncertainty over the best way for the sector to meet some of these targets in particular in relation to reducing greenhouse gas emissions and spills from storm overflows. We want to push the sector to transform performance and make improvements as quickly and efficiently as possible, so have taken additional steps to drive this and allow companies to make faster progress towards long-term targets.

Companies should make substantial greenhouse gas emission reductions as they progress towards national government targets on **net zero.** We expect concerted action to address both operational and embedded emissions in parallel.[137] Companies should propose stretching improvements to operational GHG emissions from base allowances during 2025-30 having started from an efficient level in 2025-26. We will compare company performance for

[135] Joint Ofwat & EA letter issued to all English companies in September 2022.
[136] We are open to the same approach in Wales.
[137] Ofwat, 'Net zero principles position paper', January 2022.

wholesale water and wastewater services to ensure that proposed improvements through base are ambitious.

We expect companies to deliver standard enhancement activities in a way that minimises the impact on emissions, for example through nature-based solutions where these are evidenced as best value. However, we also want companies to go further than this and will allow additional funding for specific net zero enhancement investments. Where companies are making stretching operational GHG emission reductions, we will allow net zero enhancement funding requests on a competitive basis through setting a net zero challenge. We will aim to concentrate funding on those companies with more mature approaches to emission reductions and more efficient solutions. This will ensure that the additional, further, faster improvements are made at the lowest cost. We would expect learning to be shared across the sector. The impacts of base improvements and all enhancement activity will be included within company PCLs.

The impact of **storm overflows** on our rivers is not acceptable. Companies must be compliant with their legal obligations. They must produce ambitious long-term plans and to begin immediately to reduce harm from storm overflows, protect public health and improve people's enjoyment of the environment. To meet this challenge water companies should think long-term and explore new technologies and solutions, strengthen supply chains, build new partnerships and to take a system-based approach to meeting environment objectives. We will intervene where we consider companies' plans lack ambition.

The UK government's SPS expects us to challenge water companies to demonstrate how they will significantly reduce the frequency and volume of sewage discharges from storm overflows.[138], Defra's storm overflows discharge reduction plan sets targets for companies in England up to 2050[139]. In Wales, we expect companies to propose storm overflow investments where there is evidence that they will improve river water quality, drawing on the work of the Wales better water quality taskforce.

We recognise that the reduction of spills from storm overflows will come from base and enhancement expenditure. Companies are required, through their statutory obligations, to have systems in place to ensure catchments are effectually drained and sewage is effectually dealt with. Companies have long-standing environmental obligations including, for example, environmental permits set by the Environment Agency and their general duty under section 94 WIA91, as supplemented by the Urban Wastewater Treatment (England and Wales) Regulations 1994 (UWWTR)), compliance with which is funded through base revenue. Companies should only seek enhancement investment when they can demonstrate that the investment is needed to meet a requirement beyond these pre-existing legal obligations, and we will require evidence for instance, that enhancement revenue is not being sought in relation to a compliance issue on a pre-existing permit or other UWWTR related requirement. We are currently conducting an investigation into how all water and wastewater companies in

[138] Defra, 'The government's strategic priorities for Ofwat', March 2022.
[139] Defra, 'Storm overflows discharge reduction plan,' August 2022.

England and Wales are managing their sewage treatment works and we reserve the ability to revisit our PR24 methodology and/or our draft and final determinations in view of relevant findings.

In our draft methodology we proposed to incentivise companies through a performance commitment based on the average numbers of spills per storm overflow. Although some stakeholders disagreed with this choice, we propose to continue with it. The proposed PC covers investment across base and enhancement and thus incentivises companies to maximise benefits in both areas. It is a simple metric that is widely understood and is based on a data set that is available, and the best proxy we currently have for environmental harm. It will therefore help to incentivise companies to make quick and efficient progress towards UK government and Welsh Government ambitions. At future price reviews, when better information on river health becomes available, we may consider alternative performance commitments that focus on harm done.

In our draft methodology, we set the initial level of this performance commitment at 20 spills per storm overflow. This level was partly based on commitments from Anglian Water, Northumbrian Water, Severn Trent Water and South West Water for 2025.[140] We expect all companies to reduce their use of storm overflows and go further where their legal obligations require. We expect companies to deliver the commitments they made in their river water quality action plans.

We will, however, consider evidence provided by companies in setting the PC level for 2025 and the improvements over AMP8. Where appropriate, companies should challenge themselves to go beyond our target of spills proposed in our draft methodology. We expect companies to provide evidence that the 2025 PCL reflects well-maintained assets compliant with legal obligations. Companies all have common duties related to their sewerage system, but we are conscious that external factors outside their control may impact the challenges a company faces in reducing spills. We will consider whether evidence provided by one company in setting its PC level is relevant in setting the PC level for others.

We expect companies to propose price control deliverables alongside this common PC. The PCDs should incentivise more targeted areas of enhancement investment, i.e. focus on storm overflows causing the greatest harm and other areas of importance to UK and Welsh governments, stakeholders and customers. We will set the balance of financial incentives between the PC and PCDs to reflect risk and the relative priorities of respective government, stakeholders and customers. On assessing these plans, we may consider adjusting PCDs where companies lack ambition.

We expect English and Welsh companies to deliver long-term water demand reductions for **leakage and per capita consumption**. We expect all companies to deliver a minimum

[140] Ofwat, 'Response to wastewater company river water quality action plans', June 2022.

reduction of 50% in leakage and a PCC level of 110 l/h/d by 2050.[141] Comparisons of leakage performance across English and Welsh companies indicates that some companies have managed to achieve significantly lower leakage levels than others. We expect those with higher leakage levels to challenge themselves to go beyond these targets. We also expect English companies to deliver the long-term water demand target that the UK government expects to set through secondary legislation.[142] We expect companies to maximise the benefits available from technology and opportunities to collect increasingly detailed demand data on a near real time basis. We expect companies to work collaboratively to introduce national standards for the data collected from smart meters to ensure interoperability across the sector. Consistent with the UK government expectations for water resource planning we expect all companies to consider smart meter solutions as the standard meter installation type.[143] We will challenge company proposals through the WRMP24 process and will adjust companies' proposed PCLs where they lack ambition.

To help the sector make the transformation that it needs to meet future challenges, we will retain and increase the size of the **Innovation Fund** to at least £300 million in PR24. Following the positive feedback to the April 2022 consultation on the future of the fund[144] we will continue to work with the sector and review evaluation insights over the next year. We aim to consult in early 2024 on how the fund can continue to stimulate and increase innovation to help meet the strategic challenges facing the water sector and help to transform water company performance.

We also propose to introduce a new **water efficiency fund** of up to £100 million to facilitate the development of transformative improvements to water efficiency at a regional and national level to help to reduce demand for water.

Facilitating efficient long-term investment

We want to **facilitate efficient long-term investment,** so the right interventions are delivered, and investments sequenced appropriately. We are proposing to do this in this methodology in five ways: a focus on Direct Procurement for Customers (DPC – see Chapter 3), facilitating multi-period investments, funding appropriate preparatory work, the continuation of strategic regional water resources development funding through a streamlined gated process, and the retention of transition funding.

We are keen to facilitate **multi-period investments** whilst also protecting customers. These will be where investments span multiple price control periods, notably where schemes take

[141] We discuss further in Appendix 9 - Setting expenditure allowances how our expectations align to statutory requirements, relevant government targets, expectations and priorities.
[142] The Government will set both the details of the target and statutory deadlines, through secondary legislation. A target of a 20% reduction in distribution input per head of population by 2037 was previously consulted on in Defra, 'Consultation on environmental targets', 2022.
[143] We expect both English and Welsh companies to consider smart meters as the standard meter type and collaborate on common standards. We discuss this further in Appendix 9 - Setting expenditure allowances.
[144] Ofwat, 'Innovation fund consultation – Approach for 2022-25', April 2022.

several years to design, construct and commission. Where these schemes are delivered through DPC (or Specified Infrastructure Projects regulations, SIPR), risks associated with these long running investments will be mitigated through contractual arrangements. Further details are set out in Appendix 5: Direct procurement for customers.

For other multi-period schemes, we want to allow companies to deliver these efficiently while protecting customers. We expect incentive arrangements to apply separately to each price control period. For the proportion of the scheme scheduled to be delivered in 2025-2030, companies would be subject to cost sharing and delivery risk during 2025-2030. For the proportion of the scheme scheduled to be delivered in subsequent periods then companies should request a new expenditure allowance, based on updated evidence on scheme costs. Companies would not be able to request additional costs for elements scheduled but not completed in the previous period. In very exceptional circumstances, for very large schemes and where DPC is not suitable, we will consider company proposals for bespoke arrangements where they are in customers' interests and are required for the scheme to proceed.

We will allow **enhancement funding in cases where preparatory work is essential** to start work on schemes even where there is still uncertainty of need. This would apply where schemes are multi-period and preparatory work is needed in advance of confirmation that the scheme is required. We would expect all cases to be clearly identified and strongly linked to long term delivery strategies and associated with an adaptive pathway. Preparatory investment for activities such as pre-planning application activities or part-delivery of the scheme, would be over and above normal option investigation, development, and appraisal activity, which is covered through base expenditure allowances.

We will continue to allow funding for **the development of strategic regional water resource solutions**. This is expected to be for fewer schemes and subsequently less costs than at PR19. The funding will be subject to a streamlined gated process. Further details are set out in Appendix 9: Setting expenditure allowances.

We will maintain and expand the role of the **transition expenditure programme** at PR24, which will allow companies to bring forward some planned investment from 2025-30 to this price control period. For PR24, we will allow transition funding for 2023-24 (and 2024-25) to allow companies to make an early start on certain schemes, where early delivery helps reduce overall delivery costs in 2025-30 and helps earlier delivery of customer and environmental benefits. But we expect any issues that we have identified with any schemes proposed to have been addressed. We will assess the efficiency of transition expenditure as part of the PR24 draft and final determinations, alongside other PR24 expenditure. As such these costs will be subject to the same scrutiny and challenge as all other enhancement costs. Further details are set out in Appendix 9: Setting expenditure allowances.

Delivering for customers and the environment over the long term

We want to ensure that customers and the environment are protected from the non-delivery of funded schemes. The outcomes regime already provides a degree of protection to customers as Outcome Delivery Incentives give money back to customers where an outcome is not achieved.

We expect companies to identify in their business plans how customers will be protected against under or non-delivery of funded enhancements. This will either be by identifying clearly quantified impacts of enhancements on performance commitments (common or bespoke) and accounting for these in PCLs. Or where the investment is material, but the outcome cannot be directly linked to a performance commitment – by setting a price control deliverable.

Price control deliverables (PCDs) will allow enhancement funding to be returned to customers in the event of under- or non-delivery of outputs or outcomes associated with enhancement expenditure. These outputs or outcomes are not fully reflected in performance commitments and ODIs. PCDs can apply to direct outputs or benefits of investment such as volume of water delivered or wastewater storage. They can also cover wider scheme benefits such as embedded carbon emission reductions. PCDs should cover each of the key outputs or benefits identified for enhancement proposals. If these outputs or outcomes are not delivered, then the price control deliverable will return the associated enhancement funding to customers.

PCDs should also be used to identify benefits from enhancement funding that are expected to be delivered after the end of the next price control (ie after 2030). This should encompass not only direct outputs but also the expected impact on performance commitment levels. Reflecting these benefits in price control deliverables provides customers the transparency of expected future deliverables and companies with additional regulatory certainty over how our outcomes regime may take account of these benefits in PR29. Price control deliverables should also be used to track the intermediate milestones and outputs/outcomes expected from multi-period schemes which may get funded at PR24, both during the 2025-2030 period, and beyond.

PCDs should also set out the associated under delivery payments. Customers should not lose out if improvements are not delivered. If companies fail to deliver improvements then the PCD payments, together with any related ODI underperformance payments and cost sharing arrangements, should return to customers more than the allowed cost of the enhancement, and should reflect any foregone benefits. PCDs should be spread across 2025-30 to reflect expected improvements within the 2025-30 period as well as at the end of the period.

We expect that meeting government targets and regulatory and statutory requirements is likely to lead to a significant increase in enhancement expenditure. We expect companies to ensure that they can deliver their proposals and put in place measures to ensure that they are confident that improvements can be delivered. We will facilitate delivery through transition funding. We will require companies to provide board assurance on deliverability and supply chain availability. If companies do not deliver improvements, they will return to customers more than the allowed cost of the enhancement.

6.7 Companies should deliver best value

Companies providing greater public value is a key part of our strategy. One of the three strategic goals in our 2019 Strategy, 'Time to act, together', is 'For water companies to provide greater social and environmental value, **delivering more for customers, communities, and the environment**.'

Delivering wider value is also a main theme in the UK government's SPS and Welsh Government' SPS. One of the four strategic priorities in the UK government's SPS is for Ofwat to "challenge the water industry to plan, invest in, and operate its water and wastewater services to secure the needs of current and future customers, in a way which delivers value to customers, the environment and wider society over the long-term". Similarly, one of the strategic objectives in the Welsh Government's SPS is for Ofwat to challenge companies 'to deliver value for money for customers, communities and the environment" and " to deliver best value solutions through their regulatory framework".

We want companies to deliver enhancement schemes which are best value. Best value schemes are those that generate the greatest economic benefit for customers, the environment and society, compared to costs, over the long-term. Best value should take account of factors such as short term and long-term risks, the uncertainties around the costs and benefits of the scheme and the flexibility and adaptability of the scheme to meet future needs. It should also take account of the impact of the scheme on the **affordability** of customers' bills.[145]

Assessing best value requires considering all the potential benefit and cost impacts of a scheme. There can be a wide variety of benefits from schemes beyond that of the primary scheme purpose. These can encompass environmental and biodiversity improvements and social benefits such as public health, wellbeing and recreation. These benefits need to be compared against the costs of the scheme to assess the value that the scheme would bring to customers, the environment and society.

We are keen to promote best value as part of PR24. We want to support enhancement schemes that deliver **additional environmental and social benefits which outweigh any additional costs**. Not all schemes that generate additional benefits will necessarily be best value. Schemes where additional costs outweigh the additional benefits will not be best

[145] Further considerations in relation to best value solutions are set out in the WRMP and WINEP guidelines.

value.[146] Least cost schemes can be best value where alternatives offer smaller net benefits (even when these alternatives are value for money). Therefore, companies should consider a variety of options to identify the best solution for customers, the environment and society.

We expect the additional benefits that most influence the choice of solution to be **measurable and robustly demonstrated**.[147] Benefits that are not measurable or robustly demonstrated should not be a significant driver of cost. Benefits that are likely to be easier for companies to demonstrate robustly include operational carbon and biodiversity benefits (both of which have common standards and can be tracked through performance commitments). We set out our expectations on how companies should assess best value and evaluate wider benefits in more detail in Appendix 9: Setting expenditure allowances. Our approach to assessing best value builds on our public value principles.

We also want companies to make a **step change increase in the use of nature-based solutions at PR24**. We have introduced a suite of changes to our methodology to facilitate this step-change. We summarise these policy changes in section 6.4.2 of Appendix 9: Setting expenditure allowances. These changes include our consideration of wider environmental and social benefits in our assessment of enhancement expenditure; new performance commitments in areas where nature-based solutions tend to perform better than traditional solutions, such as GHG emissions and biodiversity; and our quality and ambition assessment of business plans which will make rewards available to those companies which show (among other factors) more ambition in relation to i) delivering stretching performance from base expenditure allowances and ii) using best value solutions to deliver requirements.

In addition to the above policy changes, we want to provide a more level playing field between traditional solutions and non-traditional solutions.[148] We will set a **ten-year ongoing operating expenditure allowance** (to be recovered over two price control periods) for non-traditional solutions which are wholly or primarily on-going operating expenditure (eg, catchment management solutions). This should close the potential funding gap for these types of solution while not overly increasing the complexity of our regulatory framework. In ten years' time, at PR34, we can assess whether an additional allowance for another regulatory period is required. We will continue to work with relevant regulators to remove any outstanding barriers for the use of nature-based solutions where appropriate.

[146] Furthermore, a scheme cannot be "best value" unless it delivers outcomes consistent with companies' legal duties.
[147] This is consistent with the WINEP Options development guidance which states that for the WINEP's wider environmental outcome benefits to be accounted for in the options development process, companies must be able to robustly demonstrate how and when your investments will contribute to the WINEP wider environmental outcomes (see WINEP Options development guidance, p. 11). In this context robust means that measurements are not unduly open to bias or manipulation, and that any such influences can be effectively mitigated where they exist. Demonstrability means investment impacts should be observable in a way that can be objectively recorded and reported on.
[148] There is currently a funding gap for non-traditional solutions which are wholly or primarily operating expenditure based. Operating expenditure for enhancement projects is currently reported as enhancement for a single price control period. It is then reported as base in the next control period, but it is not reflected in the base cost econometric models for another five years since the models are backwards looking.

We expect companies to give due consideration to the use of nature-based solutions when identifying the best option for customers, communities and the environment. We will not support funding of enhancements for which companies have not given consideration to the use of nature-based solutions in a fair, consistent and transparent way.

We are concerned about the impact that additional benefit schemes could have on customer bills. Consistent with our public value principles, companies should only seek to create further social and environmental value in the course of them delivering their statutory functions. Where companies seek to go beyond what is necessary to meet their statutory requirements and deliver wider benefits at a greater cost for customers, we will require companies to demonstrate **evidence of customer views**.[149] We also expect companies to ensure that their package of enhancement proposals is affordable to customers and provide evidence to demonstrate this.

As customers may pay more for enhancement schemes which deliver additional benefits, we intend to monitor the delivery of these benefits and for companies to reflect these benefits in performance commitments or price control deliverables where possible. Benefits which are not linked to a performance commitment or price control deliverable should not be a material driver of overall costs and should be reasonably modest.

Delivering wider benefits does not need to be at greater cost to customers. One way this can be achieved is if companies **work in collaboration with others**. Where third parties (eg local authorities, farmers, estate developers, community groups, catchment partnerships) derive material benefits from the scheme, we expect companies to work with these parties and leverage a fair share of contributions from them where this is efficient to do so. Consistent with our public value principles, we expect these contributions to be in proportion to the benefits that third parties derive from the scheme.[150] We set out our expectations on partnership contributions in more detail in Appendix 9: Setting expenditure allowances.

[149] This is consistent with our public value principles which state that the delivery of social and environmental value outcomes should not come at a greater cost to customers without evidence of customer views. See Ofwat, 'Ofwat's Final Public Value Principles,' March 2022, p. 6.
[150] See Principle 5 of Ofwat, 'Ofwat's Final Public Value Principles,' March 2022, p. 7.

7. Aligning risk and return

7.1 Introduction and summary

In this chapter we discuss the alignment of risk and return, our approach to setting allowed returns and the notional capital structure, the treatment of inflation, and our approach to RCV indexation and setting tax allowances. Our aim for PR24 remains to align the interests of companies and investors with those of customers, so that the sector is attractive to investors, but companies can only earn high returns from great performance.

We also set out our methodology for setting the allowed return for PR24, and give our 'early view' of this figure. We will update it for draft and final determinations using our stated methodologies and up-to-date market data.

This chapter covers our approach in the following areas:

- aligning risk and return (Section 7.3);
- our approach to the allowed return (Section 7.4);
- our approach to inflation (Section 7.5);
- our approach to RCV indexation (Section 7.6);
- our approach to the notional capital structure (Section 7.7); and,
- our approach to corporation tax (Section 7.8).

We set out further detail on our approach in the following appendices:

- Appendix 10: Aligning risk and return.[151]
- Appendix 11: Allowed return on capital.[152]
- Appendix 13: Data and modelling.[153]

The policy set out in this chapter and the associated appendix draws on the consultation for our risk and return discussion paper, a subsequent workshop and the consultation for our draft methodology.

[151] Ofwat, 'Creating tomorrow, together: Our methodology for PR24, Appendix 10: Aligning risk and return', December 2022.
[152] Ofwat, 'Creating tomorrow, together: Our methodology for PR24, Appendix 11: Allowed return on capital', December 2022.
[153] Ofwat, 'Creating tomorrow, together: Our methodology for PR24, Appendix 13: Data and modelling', December 2022.

7.1.1 Key messages

- **Our methodology seeks to allocate risks to those best placed to manage them,** and **align company and investor interests with those of customers** so that the sector is attractive to investors, but companies only earn high returns from great performance.
- **Companies will be required to assess and report on risks around their business plan using return on regulatory equity (RoRE).** This will provide insight into the balance of risk and return, and the strength of incentives proposed in business plans.
- **We will use the capital asset pricing model (CAPM) as our primary approach for setting the allowed return on equity**. We do not envisage departing from the CAPM-derived estimate of the allowed return unless there is compelling evidence from market-based cross-checks.
- **We set out our proposed methodology for determining the allowed return on capital.** Following this methodology, we calculate an 'early view' allowed return on capital for PR24 for the appointee of 3.29% (CPIH, real). This is based on an allowed return on equity and debt of 4.14% and 2.60% respectively, and a data cut-off of 30 September 2022. We expect companies to use this allowed return in their business plans or provide compelling evidence that another rate is more appropriate.
- **The 'early view' allowed return is set on the basis of a fixed allowed return on equity** on the grounds that our previous work found the net benefits of indexation do not clearly support a move to index the allowed return on equity. Our 'early view' risk-free rate is based on a 1 month trailing average of data up to 30 September 2022. We have used this date as our data cut-off as we expect to use it in 2024 for our final determinations. However, reflecting that our 'early view' has been set in a period impacted by volatility and movements in interest rates, we keep open the option to use a longer trail of historical data for setting our draft and final determinations in 2024, reflecting the evolution of interest rates.
- **We retain the option to re-open the question of risk-free rate indexation should comparable volatility in interest rates persist into 2024.** Reflecting that our 'early view' allowed return has been set in a period that has been impacted by volatility in interest rates, we illustrate that the allowed return would be 3.53 % (CPIH, real) based on a 31 October 2022 cut-off.
- **Our 'early view' allowed return reflects the Bank of England's 2.0% inflation target.** We may however revisit it for draft and final determinations, if this assumption is not likely to be a reasonable forecast of inflation over 2025-30.
- **We will focus on balance sheet debt to set our cost of embedded debt allowance.** The cost of embedded debt in our 'early view' is only marginally lower than that set at PR19; reflecting recent increases in interest rates which we assume will be reflected in the cost of debt raised ahead of 2025 and included in our allowed cost of embedded debt for 2025-30.
- **We will set a separate, indexed, allowance for new debt.** For our 'early view' allowed cost of new debt we have adjusted our benchmark index down by 15 basis points. This

reflects historical water bond yield evidence suggesting the notional water company should achieve a yield at issuance discount to the index at least as large as this.

- **We will simplify assessment of requests for company-specific adjustments to the allowed return on debt.** We propose to allow a 30bps uplift to the allowed cost of embedded debt where small companies provide compelling evidence that customers support such an uplift. We will discontinue the requirement for cost-benefit analysis as a precondition for award of an uplift.
- **We will fully index the RCV to CPIH** from the start of the 2025-30 control period. This will ensure that water bills are no longer influenced by the discredited and upwardly-biased RPI measure and will allow for a simpler suite of PR24 reconciliation models.
- **We will set notional gearing at 55% at PR24.** This is five percentage points lower than PR19. It reflects our view that there is a stronger case for equity in the notional capital structure. We consider a reduction in gearing of c.5% compared with PR19 is achievable for the notional company ahead of 2025, taking account of the benefits of high inflation for equity in the current regulatory period. Signalling our decision now provides companies the opportunity to revisit and align their structures with the notional level ahead of PR24 should they wish to.
- We will set **tax allowances at the wholesale level and for each wholesale control** and set the **margin for the retail controls to include an allowance for tax**. We propose to retain our PR19 mechanism for passing through significant changes in elements of the tax framework outside company control such as the corporate tax rate and capital allowances. We confirm we will adopt a symmetrical approach to tax clawback arrangements where companies with gearing levels that are above the notional level inject equity to strengthen their financial resilience in 2025 to 2030.

7.2 Responses to our draft methodology

Respondents generally continued to support the use of RoRE analysis in the assessment of risk, however several respondents argued that our proposals entailed greater risk than at PR19 and were skewed to the downside. Respondents referenced specific aspects of the PR24 policy proposals and the wider backdrop against which our determinations will be set (including challenges associated with company performance and wider macro-economic impacts on companies) as reasons why risk was perceived to be greater at PR24.

While broadly agreeing that we should use the CAPM as the framework for setting the allowed return, company respondents raised concerns around our estimation approach on every allowed return parameter, and raised concerns we were not proposing to follow many aspects of the methodology adopted by the CMA panel in its PR19 redeterminations. Company respondents also criticised the approaches we proposed as cross checks to the allowed return on equity. Several companies requested that we set the allowed return with greater reference to company-specific characteristics, particularly small size. Company and investor respondents typically disagreed with the view set out in our draft methodology that there may be a case for a stronger role for equity in the notional capital structure.

Respondents did not oppose our proposal to fully transition indexation of the RCV to CPIH from 2025. However, some companies requested an allowance to account for their RPI-linked liabilities and higher CPIH-linked issuance costs.

We set out our considered responses to all of the issues set out above in Appendices 10 – Aligning risk and return and 11 – Allowed return on capital. In section 7.2.1 we summarise the key changes we have made to the proposals in our draft determination.

7.2.1 Key changes from our draft methodology

We have considered carefully the overall balance of risk and return implied by our draft methodology. Our aim in setting our determinations is to set a risk and return package that allows efficient companies to have a reasonable prospect of earning the base allowed return. We have made some targeted revisions to the overall risk and return package which are presented in our revised, illustrative, RoRE ranges. Companies will have opportunities to earn higher returns for delivering exceptional performance. We will keep the overall balance of risk and return under review through to our final determinations.

We provide our 'early view' of the allowed return based on data up to 30 September 2022. In setting our early view, we have considered carefully the arguments and evidence put forward in responses to our draft methodology. For instance, we have reconsidered our draft methodology proposal to constrain debt beta to achieve an allowed return that is not sensitive to gearing. In addition, we propose to focus on a longer span of beta data than at PR19. We retain market-to-asset valuations as an important cross check to the allowed return on equity.

7.3 Aligning risk and return

In this section we explain how we aim to calibrate the PR24 risk and return package to align the interests of companies with their customers.

There are two key considerations in risk assessment – likelihood and impact. If a company shares in the consequences of a risk it can influence, it will have an incentive to manage down the risk’s likelihood and impact, which can lead to better outcomes for customers. Even in circumstances where a company cannot manage the likelihood of a risk materialising, a company can have a critical role in managing impacts, and where impacts are managed efficiently, this can also lead to better outcomes for customers. Our methodology nonetheless limits the exposure of companies to risks (or the consequences of risks) they cannot effectively manage or control, including through reconciliations and uncertainty mechanisms. [154] We do this because such risks can place upward pressure on customer bills as companies would otherwise tend to require a premium for bearing such risks.

7.3.1 Managing risk and uncertainty

Companies continue to benefit from a number of risk and uncertainty mechanisms. These include those incorporated into company licences (such as the interim determination mechanisms), the operation of the regulatory regime and the suite of risk sharing and reconciliation mechanisms that are included in price review determinations (as set out in Appendix 13 – Data and modelling).

As proposed in our draft methodology, we have sought to rationalise the number of reconciliation mechanisms with the aim of reducing unnecessary complexity and regulatory burden.[155] We intend that there will be a high evidential bar for accepting notified items[156] or bespoke uncertainty mechanisms, as our existing suite of risk-sharing and reconciliation mechanisms already provide significant protection for companies. There is no automatic presumption that PR19 mechanisms will be rolled forward to PR24. We set out further detail on how companies should evidence requests for uncertainty mechanisms in Appendix 10 – Aligning risk and return.

7.3.2 Analysing the balance of incentives

We retain Return on Regulated Equity (RoRE) as a tool for assessing the financial risk companies may face at PR24. We consider that RoRE remains an important metric for understanding the relative magnitude of returns at risk and helps to illustrate the expected risk and return balance at PR24.

Companies will be required to assess and report on risks around their business plan by reference to RoRE analysis for the notional structure. We expect companies to properly consider the scope for upside as well as downside performance. Companies should explain the assumptions and calculations underpinning their risk ranges. This is particularly important where a company makes proposals that alter the allocation of risk between companies and customers that are in the company's favour. We set out our requirements for these proposals in Appendix 10 – Aligning risk and return.

[154] Including for example reconciliation mechanisms for changes in corporate tax rates and capital allowances and indexation of the cost of debt.
[155] We confirm we will discontinue the RPI-CPIH wedge reconciliation, the bilateral entry adjustments model, the developer services revenue adjustment and the WINEP reconciliation model.
[156] A "notified item" is an item we specify that has not been allowed for (either in full or not at all) in our price control determination. Notified items are (together with the relevant changes of circumstance specified in company licences) eligible for consideration as part of an interim determination.

Figure 7.1 sets out our view of the balance of incentives faced by the notional company at PR24 and is broadly symmetrical at – 4.85% to +4.80%. Compared with our draft methodology, the presentation of RoRE ranges has been updated to reflect notional gearing of 55%[157] and other policy changes in our final methodology.[158] This assessment is based on historical performance data and our final PR24 policy positions; expressed as a range between the 'reasonable downside' (P10) and 'reasonable upside' (P90), averaged over 5 years at a company level.

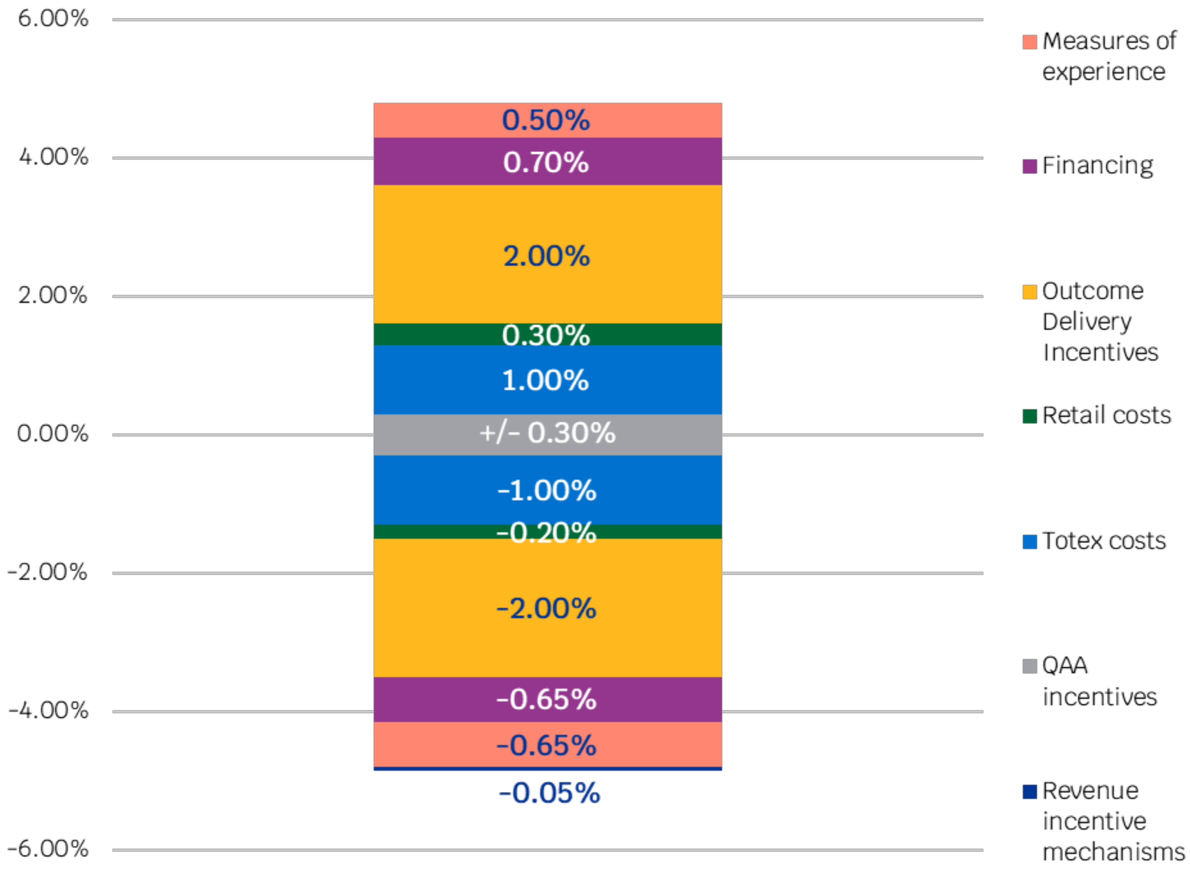
The presentation is illustrative, but we consider that our overall package at PR24 is likely to put a similar level of returns at risk as at PR19.

Compared with PR19, we are intending to strengthen the customer measure of experience (C-MeX) incentive and adding a new incentive to improve outcomes for business customers in England (BR-MeX). We have also strengthened the Quality and Ambition Assessment incentive (QAA) and we have more symmetrical cost sharing rates than at PR19.

On outcome delivery incentives, we have introduced the aggregate sharing mechanism that shares net outcome delivery incentive payments between customers and companies once they reach certain thresholds each year. We will also set symmetrical incentive rates for individual performance commitments by default. We have also removed enhanced underperformance payments while expanding enhanced outperformance payments for all companies on six performance commitments. We also aim to increase the strength of incentive rates by linking payments to a higher proportion of marginal benefits, which should further incentivise companies to improve their performance.

[157] Where incentives such as ODIs and the quality and ambition assessment incentive remain scaled in RoRE terms, at a gearing of 55%, the incentive payment in monetary terms is greater than for the notional structure illustrated in the draft methodology (notional gearing 60%). Risk ranges that are scaled to other items (such as totex) have narrower RoRE impacts than illustrated in the draft methodology as a result of out and under performance being spread over a larger notional equity base than presented in the draft methodology. For ODIs we retain an illustrative RoRE range of +/-2%.
[158] These issues are discussed further in Appendix 10 – Aligning risk and return.

Figure 7.1: Indicative PR24 RoRE risk ranges for the notional company[159] [160]



Source: Ofwat analysis of historical company performance data
Note**:** Figures are expressed as variation from the CPIH-real base return.

7.4 Our approach to the allowed return

We will set the allowed return on the basis of a weighted average cost of capital (WACC) to all wholesale controls and a retail margin for the retail controls, as we did at PR19. In both cases, we propose to set the allowed return by reference to an efficient company with the notional capital structure. For retail financing costs we propose to retain an allowance in the form of a net margin on the revenues attributable to residential supply. We will in addition set net

[159] Measures of experience refers to the three incentives; Customer Measure of Experience (C-MeX), Developer Measure of Experience (D-MeX) and the Business Measure of Experience (BR-MeX). Impacts in the chart are shown as an average annualised impact over the 5-year control period at a company level.
[160] For simplicity we have presented the overall range as the additive sum of parts, however, we expect the overall range achieved in practice is likely to be narrower as it is unlikely that a company would experience all P10s or all P90s for the categories in Figure 7.1 over the five-year control period. We explain the calculations underpinning this figure in Appendix 10.

margins for business customers of Welsh companies for the majority of business customers that do not have the ability to change suppliers.[161]

As at PR19, we will set a point estimate based on a review of retailer earnings before interest and tax (EBIT) margins and evidence from other sectors. For the purposes of our 'early view' allowed return we retain the 1% margin applied at PR19, but we will update our assessment of the retail margin for draft and final determinations. To avoid compensating investors twice for retail risks, we will subtract the retail margin from the appointee-level allowed return to derive a wholesale allowed return which we will apply to all wholesale controls.[162]

Some responses raised concerns that our proposals on bioresources increased risk and necessitated a higher allowed return than other wholesale controls. As set out in Chapter 3 and Appendix 4, we confirm we will only partially reform our approach at PR24, and as such we will continue to apply a single wholesale allowed return to each of the wholesale controls.

In response to our draft methodology, some companies argued for some elements of the methodology used by the CMA panel in their PR19 redeterminations. However, we also received proposals from companies and their advisers to make changes to the CMA's approach. We have carefully considered the CMA's PR19 redeterminations in our approach for PR24, but note that we - like the CMA panel - consider each price review afresh.[163] Our approach to setting the early view allowed return draws on the draft UKRN guidance for regulators for setting the cost of capital that aims to improve consistency across regulators in setting allowed returns.[164] This document has taken account of regulatory determinations by other regulators since the CMA's PR19 redeterminations.

7.4.1 Our 'early view' allowed return on capital

In the following sections, we summarise the methodology we will adopt for determining the allowed return on capital for draft and final determinations in 2024. Table 7.1 sets out our 'early view' of the allowed return for PR24 (3.29% CPIH, real) applying this methodology, and based on a data cut-off of 30 September 2022.

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[161] The retail market for business customers of Welsh companies is not open to competition except in relation to supplies of water of at least 50 Ml per year.
[162] The retail margin adjustment is designed to avoid double counting of compensation for retail risks in both the retail margin and appointee allowed return.
[163] For example, CMA set out in the RIIO-2 appeals for the energy sector that the approach adopted in its PR19 redeterminations did not represent an approach from which a regulator cannot depart. The CMA stated "while we accept that the CMA PR19 Redetermination is very recent and contains material highly relevant to these appeals, this does not mean that it sets down the unquestionable methodological best practice from which a sector regulator cannot depart, nor that subsequent findings of a sector regulator are automatically (or even presumptively) wrong if they differ from it." CMA, 2021, Energy Licence Modification Appeals Final determination Volume 2A: Joined Grounds: Cost of equity, para. 5.5 p.4.
[164] UK Regulators Network, 'UKRN guidance for regulators on the methodology for setting the cost of capital – consultation,' 2022.

We recognise that the period immediately preceding our data cut-off was characterised by a period of considerable market volatility. By way of illustration, moving our data cut-off one month forward to 31 October 2022 would have resulted in an allowed return for the appointee of 3.53%,[165] 24 basis points higher than our 'early view' estimate of 3.29%. Setting an allowed return on equity that is fixed for five years, and which remains reasonable, is challenging in the context of such volatility.

Reflecting that we are two years from our final determination, we retain the option of using a different sample of historical data from the September average used in our 'early view', taking account of the evolution of interest rates. We also keep open the option of indexing the risk-free rate should our data for draft and final determinations continue to be characterised by levels of volatility comparable to those seen in Autumn 2022.

We set out further detail in support of the calculations of the early view allowed return in Appendix 11 – Allowed return on capital.

Table 7.1: Our early view of the allowed return on capital (Real, CPIH)

	PR24 'early view' - point	PR24 'early view' - range
Cost of equity	4.14%	3.67% to 4.60%
Cost of debt	2.60%	2.60%[1]
Gearing	55%	55%
Appointee WACC	3.29%	3.08% to 3.50%
Retail margin adjustment	0.06%	0.06%
Wholesale WACC	3.23%	3.02% to 3.44%

1) Unlike the cost of equity we do not express the cost of debt as a range due to it being more observable and requiring less judgment and inference to estimate.

7.4.2 Wider market context for the expected return

The PR19 price review was carried out against a 'lower for longer' market context characterised by a prolonged period of historically low yields across a range of asset classes and expectations of slow economic growth. More recently, we have seen upward pressure and volatility on both inflation and interest rates as a consequence of macroeconomic events.

Inflation has risen to levels not encountered since the 1980s. In November the Bank of England forecast that inflation will peak at 11.0% in the final quarter of 2022 and that CPI will return to around the Bank's 2.0% target in 2 years' time; however there is uncertainty around this forecast.[166] Inflation expectations are relevant to the allowed return in terms of how to convert financial figures between different price bases. Material variations between outturn

[165] Based on an allowed return on equity of 4.42% and an allowed return on debt of 2.81%.
[166] Bank of England, 'Monetary Policy Report', November 2022.

inflation and the inflation assumption used to calculate the allowed return on debt may also drive a wedge between the actual and allowed cost of debt for the period of the control.

Upward movements on our key risk-free benchmark – index-linked gilt yields - have been evident throughout 2022. Index-linked gilt rates are likely also to be impacted by the trend for central banks (including the Bank of England) to start selling their stocks of government bonds acquired under quantitative easing programmes.[167] In addition, there was significant volatility in UK gilt yields in September 2022 following fiscal announcements made by the UK Government. Rising gilt yields carry significance for the allowed return as they feed into our estimates for the risk-free rate, new debt, and embedded debt.[168]

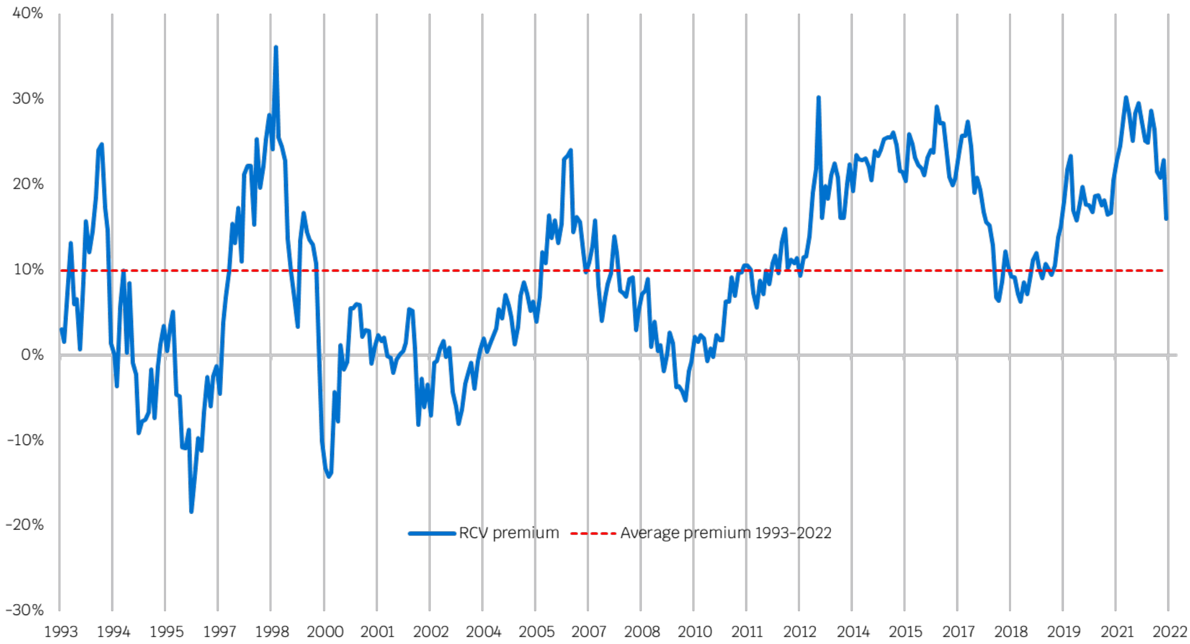
The increases in gilt yields seen throughout 2022 and the recent levels of volatility raise questions about how best to interpret inputs to cost of capital calculations and the common regulatory approach of using a sample of recent data to inform the risk-free rate, with longer trails expressing more confidence of reversion to historic norms. Higher volatility also strengthens the case for indexing observable cost of capital components such as the risk-free rate, on the grounds that fixing a multi-year assumption is more likely to result in inaccuracy.

Reflecting the considerable increase in interest rates over 2022, we have for our 'early view' chosen to adopt short trailing averages of 1 month for the risk-free rate and as an input for our calculations of the allowed return on new debt. For draft and final determinations we will however retain the option of adopting a longer trailing average to inform our assessment of for our determinations in 2024, reflecting the evolution of interest rates.[169] Should volatility in borrowing rates persist at the time we set our draft and final determinations we may need to revisit the option of indexing the allowed return on equity.

While there has been some volatility in share prices of listed water companies, Market-to-Asset ratios for listed companies have remained at or above their historical average (Figure 7.2). Evidence from Market-to- Asset valuations in Appendix 11 – Allowed return on capital supports the allowed return on equity proposed in our early view and we will continue to review the evolution of this evidence through the price review process.

[167] The first sale of gilts from the Bank's Asset Purchase Facility began on 1 November 2022: Bank of England confirms APF gilts sales for Q4 2022 | Bank of England.
[168] Gilts are a benchmark for new debt costs and so both figures tend to demonstrate co-movement. An important input to PR24 embedded debt will be PR19 new debt.
[169] In particular, this would be appropriate if there was convincing evidence that a single month-average data was not likely to be representative of 2025-30.

Figure 7.2: Monthly average enterprise value premium to RCV for listed water companies



Source: Ofwat analysis, Bloomberg equity analyst reports

Despite some estimates that it would fall substantially,[170] our 'early view' calculations suggest that the allowed cost of debt could be higher than at PR19. This is based on the assumption that the recent elevated cost of new debt persists, feeding through not only to PR24 new debt costs over 2025-30 but also to embedded debt costs via the debt incurred in the remaining years of PR19 (2020-25). Our updated view of debt costs for the remaining years of the PR19 period in 2024 will provide a more certain picture of embedded debt costs for PR24.

7.4.3 Our approach to the return on equity

Consistent with the draft UKRN cost of capital guidance for regulators, price controls across the regulated sectors, academic recommendations,[171] and other UK regulatory practice,[172] **we will retain the CAPM as our main tool for cost of equity estimation**.

Our 'early view' allowed return is set on the basis of a fixed allowed return on equity. While there has been recent volatility in interest rates, our assessment based on PwC's analysis,[173] suggests that the gains from indexing the risk-free rate are not sufficiently clear

[170] Moody's forecast in 2021 that the allowed cost of debt could fall from 2.14% to 1.68% (real, CPIH); see Moody's Investors Service (5 October 2021): Companies could face another cut in allowed returns in AMP8', 6 October 2021.
[171] Wright et al. 'Estimating the cost of capital for implementation of price controls by UK Regulators', March 2021 p. 22.
[172] For instance, the CMA's PR19 final redeterminations endorsed using the CAPM, 'Ofwat price determinations, final report', March 2021, p.33, para 84.
[173] PWC, 'Cost of equity indexation: Evaluating the case for indexation at PR24 and beyond', October 2021.

make it a priority when we come to set the allowed returns for draft and final determinations in 2024. We therefore expect to set a fixed return on equity for draft and final determinations. However, recognising that periods of significant volatility in interest rates increase the risk of setting an inaccurate allowance, we may need to revisit the question of indexation for our draft and final determinations.

We will focus on index-linked gilt yields as our primary source of evidence for the risk-free rate. These instruments have a strong claim to be risk-free at the 10-20 year investment horizon proposed in the draft UKRN cost of capital guidance, due to minimal credit and inflation risk, and are traded frequently in markets that are usually deep and liquid. In the current environment of high inflation, we consider nominal risk-free proxies unsuitable as primary evidence to inform the risk-free rate, due to the difficulty of inferring the inflation risk premium. While our 'early view' makes use of a 1-month trail of historic data, we keep open the option of adopting a longer trail for draft and final determinations, taking account of the evolution of interest rates. We do not make an adjustment to our 20 year index-linked gilt yield to account for a 'convenience yield', as we consider that there is a lack of evidence to support its existence at long-run horizons.

We will use long-run historical CPIH-deflated equity returns as our primary source of evidence to inform Total Market Return (TMR). Consistent with the academic literature on historical returns, we will proxy investor expectations of TMR using both unadjusted returns, and returns adjusted for good luck and events unlikely to be repeated. As we will index the RCV by CPIH for 2025-30, we consider that the best inflation series to generate historical real returns is also CPIH. We do not consider it appropriate to retain the use of RPI, given controversy over how to adjust for changes in data and measurement methods over time. It is also unlikely that RPI is a relevant inflation measure to investors with a long-term outlook, given it will be converged to the data and methods of CPIH from 2030.

We intend to focus on equity beta data for Severn Trent Water and United Utilities, placing most weight on longer-run daily data. Our approach captures a longer span of data (15 years) than at PR19 (5 years), reflecting the trade-off between using recent data that may in principle be more relevant as a forecast, and using a longer span of data that captures a wider range of risk events and is less influenced by outliers. We will review the case for using Pennon's data later in the price review process once more data is available covering the period since its disposal of its waste management business.[174]

We **do not intend to constrain debt beta to achieve an allowed return on capital that is insensitive to notional gearing**. Our draft methodology proposed to solve for the level of debt beta which would make the forward-looking CAPM-WACC[175] invariant to changes in

[174] Pennon completed its sale of Viridor on 8 Jul 2020, but beta data following this point is affected by the retained cash proceeds from the transaction that affect our measure of gearing.
[175] That is, a WACC based on a CAPM-derived cost of new debt and a CAPM-derived cost of equity.

notional gearing. While this would have achieved greater consistency with Modigliani-Miller theorem,[176] the resulting debt beta figures are inconsistent with other approaches.

We intend to use a central estimate from within the CAPM cost of equity range to set the allowed return. We do not envisage departing from this central estimate, unless there is compelling evidence from **market-based cross-checks** such as Market-to-Asset Ratio analysis,[177] and we have not departed from the central view in setting our 'early view'.

We discuss these issues further in Appendix 11 – Allowed return on capital.

7.4.4 Our approach to the return on debt

We will set a sector-level allowance for the cost of debt. Consistent with our PR19 approach, we will set a **fixed allowance for embedded debt,** benchmarked using company balance sheet data. We will **index the cost of new debt** by reference to a benchmark index.

We will benchmark the cost of embedded debt using balance sheet data, reflecting the approach adopted in price reviews from PR94 onwards. The approach reflects observed issuance behaviour, while maintaining clear and strong incentives to issue debt efficiently. We will use index-led approaches only as a cross-check.

We will exclude the cost of insufficiently debt-like instruments and those covered by other allowances from our balance sheet benchmarking. These exclusions encompass interest rate swaps, instruments with equity-like characteristics, junior debt, and liquidity facilities. It is important to exclude these instruments to avoid degrading the quality of an estimate that seeks to capture debt interest costs for an efficient company under our notional structure.

We will apply an adjustment to our benchmark index for the allowed cost of new debt. Based on our analysis of water bond issuance over 2015-2022, we assess that a downward adjustment of 15 basis points is reasonable, and we reflect this in our 'early view'. To provide greater predictability, we have revised the position signalled in our draft methodology and propose to set the adjustment on a fully ex-ante basis, based on data available at the time of setting determinations. We intend to revisit this adjustment taking account of evidence of further debt issuance in the run up to 2024.

We intend to set the share of new debt by reference to the refinancing and new investment needs of the sector. We previously signalled that reductions in notional gearing could be expected to come about through a greater share of equity financing in new

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[176] In theory, without market frictions and taxes, the cost of capital should be invariant to gearing. This is from the Modigliani-Miller Theorem (see e.g. Modigliani, F. and Miller, M.H., 'The Cost of Capital, Corporation Finance and the Theory of Investment,' The American Economic Review, 1958.)
[177] This approach is widely used by equity analysts, institutional investors, central banks, and academics to infer investor discount rates.

RCV, reducing new debt issuance. Based on the consequential impacts of the current high levels of inflation on the notional company, we consider that the ex-post adjustment to the share of new debt proposed in our draft methodology is not needed.

We discuss these issues further in Appendix 11 – Allowed return on capital.

7.4.5 Company-specific adjustments

We have simplified our framework for considering requests by small companies for an uplift to the allowed return on debt. Previous regulatory decisions in water have acknowledged historically more limited issuance opportunities for small water-only companies as a potential cause of higher financing costs. Reflecting the range of estimates from these decisions, we consider an uplift of 30bps over the sector cost of embedded debt allowance would be appropriate for the notional small water only company. We confirm that we will expect applicants to provide robust evidence that their customers support funding the higher cost of this uplift, achieving our standards for high quality research if it is to carry weight in our assessment. We will not however require cost-benefit analysis as a precondition for allowing the uplift as we have done in previous price reviews.

Any claimed uplift should only compensate for financing diseconomies of scale at the point of debt issuance, rather than factors more directly under management control (e.g. timing and tenor). This is consistent with our long-held view that companies and their investors should bear the risks of their choices around financing decisions.

7.5 Our approach to inflation

In common with other UK economic regulators, we have historically tended to use long-term inflation assumptions to convert cost of capital parameters between nominal, RPI-deflated, and CPIH-deflated values.

Recently high and volatile inflation has challenged this approach, as outturn inflation which differs significantly from the long-term assumption used can be an important driver of realised equity returns. This has led regulators to consider alternatives to a long-term assumption; for instance the Civil Aviation Authority for its H7 final determinations based its inflation assumptions for deflating nominal debt on the Office for Budgetary Responsibility's medium-term forecast.[178]

For PR24 we intend to use separate inflation assumptions to determine CPIH-real inputs for the risk-free rate and the cost of new and embedded debt in our allowed return calculation.

[178] Civil Aviation Authority, 'H7 Final Proposals: Financial issues and implementation', p. 64, Table 9.7.

For the risk-free rate we will use expected inflation over the remaining term of the financial instrument(s) included in our analysis to convert to a CPIH basis. In particular, we will use a combination of inflation forecast and inflation swap data to calculate an RPI-CPIH 'wedge'. We set out further detail on our approach in Appendix 11 – Allowed return on capital.

In setting the real allowed return on debt, our aim is to calculate it on a basis that allows the efficient company with a notional capital structure to recover reasonable costs over time. This is achieved if outturn inflation broadly matches the assumption that underpins our cost of debt calculations. Since the introduction of the Bank of England's 2.0% CPI target in December 2003, CPIH inflation has on average been close to this,[179] and CPI and CPIH have tracked each other closely over time.[180] For this reason, we intend to continue to use the Bank of England target for the purposes of deflating nominal debt costs over 2025-30. We may however revisit our approach if high levels of inflation persist, such that it would not lead to an appropriate balance of risk and reward between customers and investors over this period.

We set out in section 7.6 that high levels of inflation in the current regulatory period have the effect of reducing gearing levels for the notional company. We set out how we have considered this issue in Appendix 10 – Aligning Risk and Return.

Finally, as for previous determinations, we will use shorter term inflation forecasts for the purposes of carrying out our financeability assessment in the financial model.

7.6 Our approach to RCV indexation

The main objective of indexing the RCV to inflation is to protect the real value of invested capital.

Stakeholders have generally indicated support for a full transition to CPIH indexation and **we confirm we will fully transition to CPIH indexation from 1 April 2025.** A full transition to CPIH introduces benefits – particularly around legitimacy, financeability and reduced complexity – but we also acknowledged that it will initially place upwards pressure on bills. We encourage companies to consider the impact of this issue on customer bills carefully as part of their wider decision making around bill impacts for customers over 2025-2030.

We do not intend to provide an additional allowance for costs associated with the transition to full CPIH indexation. By 2025, the sector will have had nearly a decade to plan a transition to CPIH indexation,[181] and CPIH indexation provides benefits to equity investors over RPI indexation as it reduces the volatility of their investment.

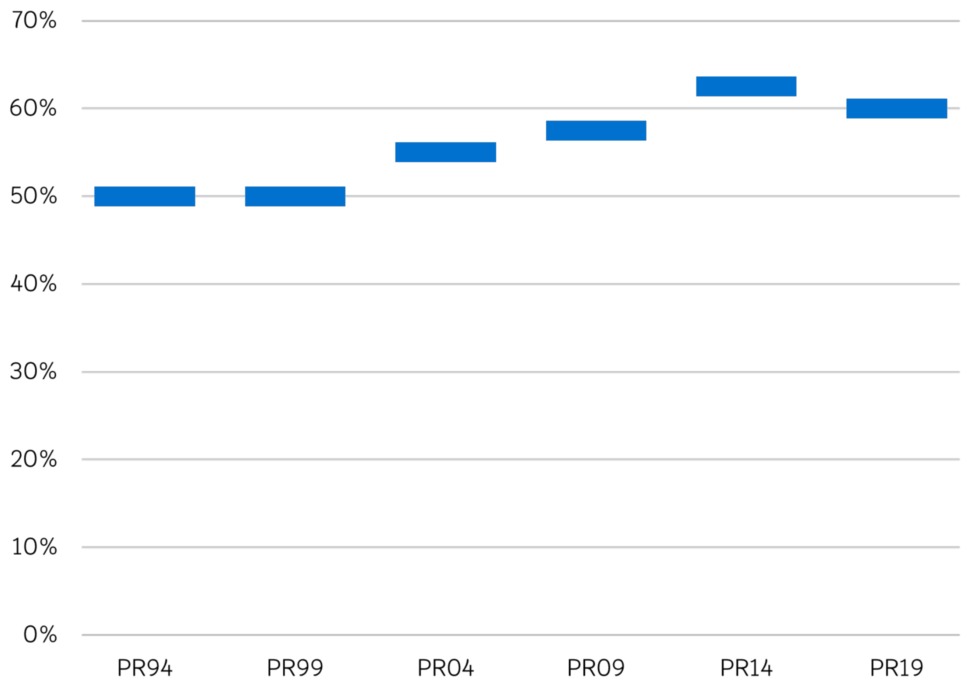
[179] Between December 2003 and September 2022, year-on-year CPIH has averaged 2.3%.
[180] We provided evidence on the closeness of CPI and CPIH inflation in Ofwat, 'PR24 and beyond: Discussion paper on risk and return', December 2021, Figure 3.2.
[181] We first mooted a transition in 2015 (see for example Water 2020: Regulatory framework for wholesale markets and the 2019 price review), following the conclusions of the Johnson review, published in January 2015.

7.7 Our approach to the notional capital structure

We set our determinations by reference to an efficient company with a notional capital structure. The use of a notional capital structure protects customers from bearing much of the risk of companies' actual financing decisions and provides strong incentives on companies to raise finance efficiently. While companies have considerable freedom to deviate from the notional capital structure, within the constraints of the price control determination, the licence and their wider obligations, they do so at their own risk.

The level of notional gearing acts as an important signalling mechanism to companies considering their own choice of capital structure, because it underpins both the allowed return and the financeability assessment. Figure 7.3 shows notional gearing has ranged between 50% to 62.5% in past water sector determinations.

Figure 7.3: Notional gearing from 1995 to 2025



Source: Ofwat analysis of price review documentation (PR94-PR19)

In our draft methodology we proposed a framework to determine the appropriate notional capital structure and signalled that we considered there may be a case for a stronger role for equity in the notional capital structure and, therefore, there may be benefits to adopting a lower notional gearing level at PR24.

No company or investor that responded to the draft methodology supported a reduction to notional gearing levels compared with PR19, however CCW agreed with our proposals. Companies argued that 60% gearing is at the lower end of the range based on market evidence, already provides a sufficient equity buffer notwithstanding any perceived increase in risk, and suggested other mechanisms may be more efficient for dealing with any perceived increase in risk associated with climate change. Some companies considered that the proposal to reduce gearing required considerable additional substantiation and impact assessment. However, two water companies suggested that if we were to reduce notional gearing, a reduction of 2.5 percentage points (to 57.5%) should be the maximum reduction.

We have considered carefully the arguments set out by companies and have determined the notional gearing that will be applied for PR24 in accordance with our stated assessment framework, which we set out in Appendix 10 – Aligning Risk and Return, and we include an assessment of the impacts of our decision Appendix 14 – Impact Assessments.

Our view remains that there is a case for a stronger role for equity in the notional capital structure. A higher equity buffer than applied at PR19 will help to ensure the notional capital structure is resilient to a more uncertain future and that it remains resilient in the context of the revenue that is at risk as a result of service performance. We consider there are benefits to adopting a lower notional gearing level at PR24, as it helps to ensure a company with the notional capital structure has the capacity to continue to raise finance efficiently to enable it to deliver the expected programme of investment. We consider a reduction in gearing of circa five percentage points is achievable for the notional company ahead of 2025, taking account of the benefits of high inflation for equity in the current regulatory period. These considerations underpin our decision to set notional gearing at 55%. We signal our decision now as this provides companies the opportunity to revisit and align their structures with the notional level ahead of PR24 should they want to.

Finally, in the current period of elevated inflation, we confirm that we would expect the notional company (and most companies under their actual structures) to reduce gearing ahead of PR24 final determinations. This is because gearing is measured as net debt divided by RCV, and where a proportion of net debt is fixed rate debt (such as in the PR19 notional company structure), high levels of inflation mean that the RCV can grow to a larger extent than net debt.

7.8 Our approach to corporation tax

Our calculation of the allowed cost of equity is on a post-tax basis and our calculation of allowed revenues includes an allowance for corporation tax. Our overall approach to tax aims to incentivise companies to manage their tax affairs efficiently – while recognising that it is important for companies to take responsibility for the tax elements of their plans – and to make sure the approach is fair to customers.

For PR19 we introduced a mechanism to make adjustments to the tax allowance for certain matters that are outside company control such as changes in the corporate tax rate and capital allowances. This ensures that customers pay no more than is implied by prevailing tax rates where tax rates are below our price determination assumptions but would pay more where tax rates turn out to be higher than assumed. We retain this mechanism for PR24.

Consistent with previous price controls, we will calculate tax allowances on the basis of the gearing that underpins the notional financial structure, or a company's actual gearing if higher. This will ensure that customers, rather than investors, benefit from any higher tax shield from interest payments. In the draft methodology we set out that we also intended to retain the policy adopted in previous price reviews to ensure that where a company increases gearing as a result of a financial restructuring, that we would claw back the tax benefits for customers as part of the next price review. We retain this policy as it removes the incentive for companies to increase gearing simply to benefit from a lower tax bill.

Two companies argued that this claw back arrangement should be symmetrical such that where companies undertake a financial restructure that reduces gearing over and above that envisaged in business plans, companies receive an allowance for the additional tax payable. We confirm we will adopt a symmetrical approach to the tax clawback arrangements where companies with gearing levels that are above the notional level inject equity to strengthen their financial resilience in 2025 to 2030.

8. Aligning risk and return: Financeability

8.1 Introduction and summary

This chapter sets out our approach to the **assessment of financeability** and **cost recovery**. This approach is designed to ensure that revenues, relative to allowed costs, are sufficient for an efficient company with the notional capital structure to finance its investment on reasonable terms, while protecting the interests of customers now and in the long term.

Each company will need to submit a plan that is financeable and provide Board assurance that it is **financeable on the basis of the notional capital structure**. Each company will need to propose **cost recovery rates** (pay as you go (PAYG) and RCV run-off) consistent with the guidance we set out, in particular, having regard to **balancing the recovery of costs between different generations of customers** and **affordability for customers**.

This chapter covers our approach to the following:

- a summary of responses to our draft methodology (section 8.2);
- approach to assessing financeability (Section 8.3);
- cost recovery for the wholesale control (Section 8.4);
- target credit ratings and proposed financial metrics (Section 8.5); and
- addressing financeability constraints (Section 8.6).

Further information on topics covered in this chapter including detailed consideration of responses to our draft methodology is set out in Appendix 10: Aligning risk and return.[182]

8.1.1 Key messages

- The financeability assessment considers whether, when all of the individual components of our determination are taken together (including totex, allowed return and retail margin, PAYG rates and RCV run-off), an efficient company with the notional capital structure will be able to generate cashflows sufficient to meet its financing needs. As part of this we carry out an assessment of financial ratios in setting our determinations.
- Within the boundaries set by the regulatory and licence framework, the choice of actual capital structure and financing is a matter for companies and their shareholders. If financeability constraints arise from these company choices, customers must not bear the costs of resolving them. We discuss our approach to financial resilience in Chapter 9.

[182] Ofwat, 'Creating tomorrow, together: Our methodology for PR24, Appendix 10 – Aligning risk and return', December 2022.

- **Each company will need to submit a plan that is financeable** and provide board assurance that it is financeable on the basis of the **notional capital structure** with an opening level of gearing of 55% (as set out in Chapter 7) and an opening proportion of index linked debt of 33%
- We will assess financeability at the **appointee level by reference to an efficient company with the notional capital structure** that underpins the allowed return on capital. We set out a **suite of cash flow financial metrics** that will be used as part of our assessment.
- Companies should provide evidence setting out how they have determined the **PAYG** and **RCV run-off rates** proposed for each of the wholesale price controls.
- Companies should explain their proposed RCV run-off rates by reference to the framework set out in section 8.4, which takes account of **intertemporal fairness, affordability, our guidance on upper limits and financeability**. Reflecting expected levels of enhancement spend and pressures on customer affordability, we would not expect companies to propose RCV run-off rates that are higher than those allowed at PR19 or that are above the guidance set out in this chapter.
- Companies should **target a credit rating of at least two notches above minimum investment grade** in their assessment of financeability of the notional company (BBB+/Baa1).
- Companies have a number of options to address financeability constraints that arise under the notional capital structure. We consider that **equity has an important role to play in funding real RCV growth** such that notional gearing does not increase materially from the opening level. Where equity is required to fund real RCV growth, we will provide an allowance for issuance costs of 2% of the equity raised. We will look for **evidence of customer views** where companies take steps to address financeability constraints through the reprofiling of cash flows between price review periods.

8.2 Responses to our draft methodology

CCW and many of the water companies generally agreed with our approach to assessing financeability. However, a number of companies argue that the allowed return is the key determinant of financeability and the financeability assessment is the most appropriate cross-check on the cost of equity. Companies also argued that changes proposed to the notional structure undermine the financeability assessment.

Some companies agree that there may be a role for equity in resolving financeability constraints, whilst other companies considered our approach has too narrow a focus on additional equity, referring back to the impact of the allowed return on financeability.

Most stakeholders agreed with the financial metrics set out in the draft methodology for assessing financeability. However, a number of companies suggested that the focus should be on metrics consistent with rating agency methodologies, that we should provide headroom to the minimum guidance at the target credit rating, and that we should set out how we intend to assess equity financeability.

CCW and a number of the water companies agreed with the proposal to set narrow bands for RCV run-off rates subject to publication of the actual bands. Some companies argued that the bands should be applied as guidance only and that RCV run-off rates outside of these bands should be allowed if appropriately evidenced. Other companies consider that the narrow bands may not reflect the differences in the make up of assets within each company.

Some companies stated that we should also assess financeability on the actual capital structure basis and that the allowed return is the primary driver of financial resilience in the sector.

We set out our considered response to all of the issues set out above in appendix 10. In section 8.2.1 we summarise the key changes we have made to the proposals in our draft methodology.

8.2.1 Key changes from our draft methodology

We confirm the approach we will adopt to the assessment of financeability in our determinations. We will carry out our financeability assessment based on an opening notional gearing level of 55% and an opening proportion of index linked debt of 33%. We intend to maintain the proportion of index linked debt at a minimum of 33% over 2025-30, with new index linked debt being linked to CPIH.

We retain our guidance that a yield of 4% should represent the maximum that is reasonable for a company with little real RCV growth, and which notches down to take account of RCV growth.

In the draft methodology, we said that we intended to set narrow bands for RCV run-off rates. For the final methodology we set a framework that companies should consider in setting appropriate RCV run-off rates including guidance on acceptable upper limits. The framework also takes account of intertemporal fairness, affordability and financeability.

We have added dividend yield to the financial metrics considered as part of the financeability assessment in the financial model as a measure of equity financeability.

We confirm that we will provide an allowance of 2% of new equity for issuance costs where new equity is raised to fund real RCV growth during the period 2025-30. We consider this allowance is consistent with the costs of Severn Trent plc's recent share placing.

8.3 Approach to assessing financeability

We interpret our financing duty as a duty to secure that an efficient company with the notional capital structure can finance its functions, in particular by securing reasonable returns on its capital. In doing so, it will be able to raise finance on reasonable terms while protecting the interests of current and future customers.

Our financeability assessment considers whether, when all of the individual components of our determination are taken together (including totex, allowed return and retail margin, PAYG rates and RCV run-off), an efficient company with the notional capital structure will be able to generate cashflows sufficient to meet its financing needs. As part of this we carry out an assessment of financial ratios to help assess the financeability of our determinations. Other parts of this include the requirement for companies to provide assurance that business plans are financeable, and a review of cost recovery rates proposed in business plans to ensure these are reasonable and do not store up a financeability problem beyond the period of the price control.

Each company should provide board assurance that its plan is financeable on the basis of the notional capital structure. This assurance should take account of all components of the business plan, including our early view on the allowed return on capital for PR24 that we set out in Chapter 7. We expect the board to set out clearly the steps taken to provide assurance, including the consideration of the financial ratios listed in section 8.5 below. We discuss financial resilience of the actual capital structure in Chapter 9.

Our overall approach will be broadly consistent with the approach adopted in previous determinations. We will consider financial ratios before taking account of the revenue impact of any adjustments relating to the previous price review periods (for example, from reconciliation mechanisms).[183] We have considered the extent to which certain reconciliations, such as the RPI-CPIH wedge and the cost of new debt, are outside of companies' control and whether it may be appropriate to include the effect of these adjustments in the financeability assessment. However, such adjustments are generally designed to make good previous shortfalls in revenue or to return excess revenue to customers, and companies can make provisions for any future reduction in revenue. Therefore, we do not make any distinction between reconciliations resulting from out or underperformance and other reconciliation mechanisms.

We will carry out our financeability assessment in our financial model which companies will be required to complete as part of their business plan submissions. We expect the financial models to be underpinned by official forecasts of inflation, for example as published by the Office for Budget Responsibility (OBR). Gearing in the financial model will be set at the

[183] Reconciliation adjustments to revenue in the draft and final determination are excluded before considering financeability to ensure incentives for companies are not diluted and customers do not compensate companies for prior poor performance. However, midnight adjustments (ie those made at the inception of the control period) to RCV do form part of the assessment.

notional level at the beginning of the price review period and may vary thereafter. We intend to retain the proportion of opening index linked debt at the same level as PR19 at 33% in the opening balance sheet. This compares to existing index linked debt of 36.7% within companies' balance sheets at 31 March 2022 (34.5% RPI linked and 2.1% CPI linked). Over the price control period, new debt will be raised by a proportion of CPI linked debt and fixed rate debt, such that the proportion of index linked debt (including accretion) does not fall below the opening level.

For business plans, companies should explain the dividend yield and growth assumptions used for their financeability assessment. This should be explained within the context of our guidance for reasonable base dividend discussed in chapter 9, that based on our early view allowed return on equity, an annual yield of 4% should represent the maximum that is reasonable for a company with little real RCV growth. We will update this assessment for our draft and final determinations, taking account of our update to the allowed return on equity.

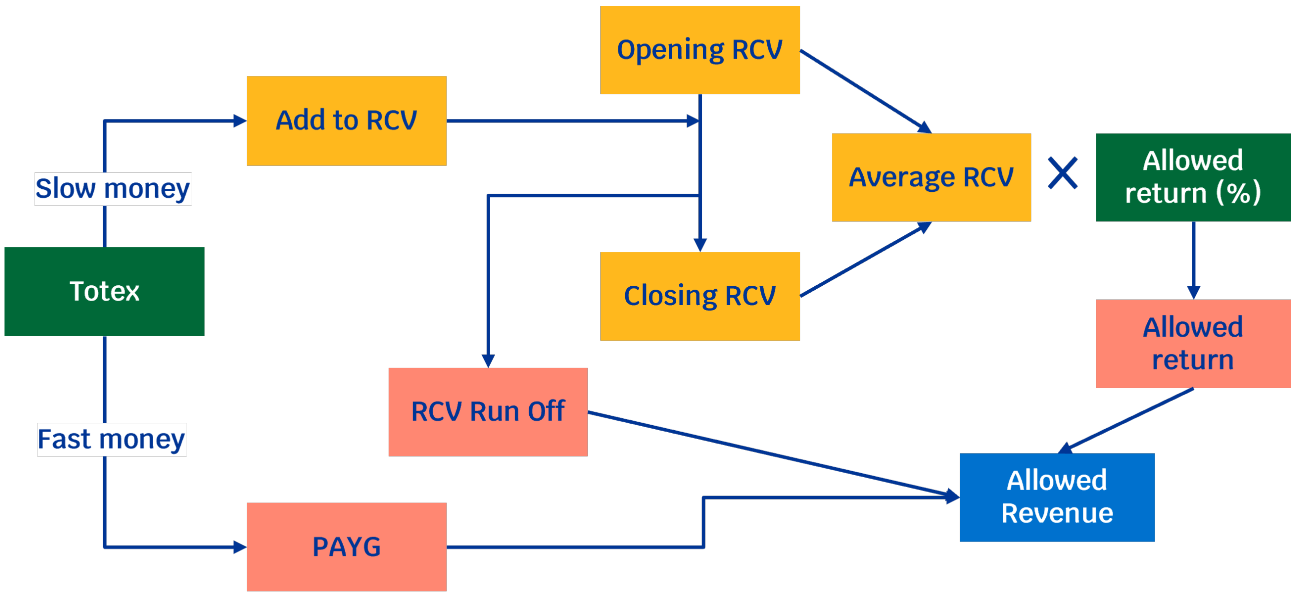
We consider that where there is significant investment in 2025 to 2030, this should be financed by a mixture of debt and equity. Therefore, we expect companies to propose adjustments to dividends and, where necessary, to provide for new equity within the financial model where gearing strays significantly from the notional level because of substantial real RCV growth. In our assessment of financeability for the determinations, we will adopt a policy approach of adjusting the dividend yield in such cases. However, in consideration of the role of dividends in equity financeability, we will maintain a reasonable minimum level of 50% of the base dividend yield in the financial model irrespective of the level of real RCV growth and, therefore, assume that additional equity financing comes in the form of new equity where RCV growth is significant. We propose to provide companies with an allowance of 2% for equity issuance costs in such cases, included as an adjustment to base allowed totex.

8.4 Cost recovery for wholesale controls

Totex allowances will determine how much companies can spend at PR24 to deliver commitments to customers and the environment, maintain the asset base and progress the agreed enhancement programmes.

Totex allowances may be funded through a mix of revenue allowances, retained earnings and the capital markets. They are recovered through allowed revenue in one of two ways. They can be recovered in the period incurred through PAYG or can be added to the RCV and recovered over a longer period through the RCV run-off (amortisation of the RCV) as shown in Figure 8.1.

Figure 8.1 Regulatory building blocks and cost recovery



- PAYG represents totex expensed in the year
- Totex not expensed is added to the RCV
- Each control has a separate RCV
- The return on RCV compensates for the investment that is in the RCV
- RCV run-off represents the amortisation of RCV

PAYG and RCV run-off rates set the speed at which companies receive the revenue which balances recovery of costs between different generations of customers. If cost recovery is too fast current customers may be paying too much. If this persists over the long-term, companies are likely to deplete their RCV which may lead to financeability constraints in the future.

Companies are required to propose PAYG and RCV run-off rates for each of the wholesale controls. Companies can propose separate RCV run-off rates for existing RCV at 31 March 2025 and new investment over 2025-2030.

In proposing PAYG rates, we expect companies to provide evidence setting out how they have identified the levels for PAYG rates for each of the wholesale price controls. We will carry out our assessment of PAYG rates taking account of evidence put forward by companies in business plans and from other sources, such as comparisons against costs incurred in the past and expectations based on the cost and investment profile in 2025-2030, including the split of operating and capital expenditure.

In proposing RCV run-off rates for wholesale controls, we expect companies to do so within a framework that takes account of:

- **Intertemporal fairness** such that the RCV is allocated fairly to each generation of customers in a way that represents how previous investment will provide services to the customers. We consider run-off rates that are based on average remaining asset lives that can be derived from published 2021-22 accounts to be a reasonable starting point.

- **Affordability** for customers. RCV run-off represents a significant element of allowed revenue and therefore customer bills. Companies will need to provide evidence that they have considered the impact of their proposals on customers both now and in the longer term and they should provide evidence of customer views on the chosen bill profile incorporating both the PAYG and RCV run-off proposals.[184]
- **Our guidance on acceptable upper limits.** Reflecting expected levels of enhancement spend and pressures on customer affordability, we would not expect companies to propose RCV run-off rates that are higher than those allowed at PR19 or that are above the guidance set out in table 8.1.
- **Financeability** of the notional company, such that the choice of RCV run-off rate balances the need to manage financeability in both the short and the long term.

We set out further detail on the issues set out above, including the calculations underpinning our guidance on acceptable upper limits for RCV run-off rates, in Appendix 10 – Aligning risk and return.

Table 8.1 - Guidance on upper limits of acceptable RCV run-off rates

	Water resources	Water network plus	Wastewater network plus	Bioresources
Upper limit	4.5%	4.5%	4.5%	8.0%

We would expect the costs for new investment to be recovered over the expected economic life of the assets produced. New RCV created over 2025-30 should be recovered over the whole economic lives of the investment programme, whilst existing RCV that has been generated over a number of years will have assets at various stages of their life cycle. Therefore, it may be reasonable to expect that RCV run-off rates for new investment are lower than for existing RCV.

We set out above our expectation that equity solutions should be considered first where a company identifies a financeability constraint for the notional capital structure in its business plan. We recognise that there may be circumstances where companies may propose adjustments to PAYG and/or RCV run-off rates that defer or accelerate cost recovery, for example to address a financeability constraint on the basis of the notional company or to profile bills across regulatory periods. Where companies propose adjustments to PAYG and/or RCV run-off rates to adjust cash flows, we expect the reasons for this to be explained clearly in business plans. Where companies propose to bring forward revenue in this way, we would expect the business plan to set out clearly how the company intends to use the additional revenue. We will not accept adjustments to PAYG and/or RCV run-off rates that are to address a financeability constraint for the actual capital structure. We consider any adjustments that

[184] Where specific customer research is being done, we expect companies to achieve the standards for high quality research. See standards for high quality research.

are to manage impacts on customer bills are best achieved through the network wholesale controls.

We set out further detail on the assessment framework we will adopt for assessing PAYG and RCV run-off rates in Appendix 10 – Aligning risk and return.

8.5 Target credit ratings and financial metrics

Financeability is an 'in the round' assessment. A range of financial metrics and other factors are used to help assess the financeability of business plans and our determinations. Each company is responsible for submitting a plan that is financeable which should include targeting a robust credit rating comfortably above the minimum requirements of the licence.

At PR19, our determinations were set on the basis of the notional company with a credit rating two notches above the minimum investment grade (BBB+/Baa1), and we consider this continues to provide a reasonable level of headroom to allow companies to cope with most cost shocks. This is a level we consider appropriate for an efficient company providing essential services over the long term. Therefore, for PR24 business plans, we expect companies to target credit ratings of at least BBB+/Baa1 for the notional company. Companies should specify the level of each financial ratio they consider appropriate for the target credit rating.

In response to the draft methodology, some companies said that proposals in the recent financial resilience consultation to increase the level of the cash lock-up means that the target credit rating for the notional company should be increased to provide headroom against the higher level. We do not consider that increasing the level of the cash lock-up to Baa2/BBB with a negative designation has any impact on the target credit rating for the notional company because the notional company should maintain adequate headroom to the trigger, where necessary with the support of its investors.

We will use the aggregated revenues, costs and cash flows across each of the price controls and as part of our assessment we will look at each company's projected financial ratios. The financial metrics we will consider are incorporated in the PR24 financial model and represent a mixture of debt and equity ratios. We have carefully considered responses to the draft methodology and have added dividend yield to the suite of financial metrics in the financial model as a further measure of equity financeability. Table 8.2 shows the ratios we collect annually from companies in annual performance reports which form the basket of metrics considered in our assessment of financeability. We place most weight on the key measures of indebtedness and the ability to service and repay debt which are gearing, adjusted interest cover and funds from operations to net debt ratios. We have set out our approach to dividends for the notional company in section 8.3 and we expect the notional company to be able to earn its allowed return on equity.

Table 8.2: Financial metrics[185]

Financial metric	Basis of calculation	What does the metric calculate?
Gearing	$\frac{\text{Net debt}}{\text{RCV}}$	Gearing measures a company's capital structure and level of indebtedness
Interest cover	$\frac{\text{FFO (pre interest)}}{\text{Cash interest}}$	Interest cover measures a company's ability to meet interest payments from operational cash flows.
Adjusted cash interest cover ratio (ACICR)	$\frac{\text{FFO (pre interest)} - \text{RCV run off}}{\text{Cash interest}}$	ACICR is a more conservative measure than interest cover. It provides an indication of interest coverage assuming companies cannot reduce the RCV run-off.
Adjusted cash interest cover ratio (ACICR) – alternative measure	$\frac{\text{FFO (pre interest)} - \text{RCV run off} - \text{Surplus PAYG revenue}}{\text{Cash interest}}$	The alternative ACICR removes any surplus PAYG revenue over operating expenses in calculating interest coverage. It assumes that surplus PAYG improves in-period cash flows without improving credit worthiness.
Funds from operations (FFO) / Net debt	$\frac{\text{FFO (post interest)}}{\text{Net debt}}$	FFO/Net debt measures a company's debt burden relative to their operational income.
Funds from operations (FFO) / Net debt – alternative measure	$\frac{\text{FFO (post interest including accretion of index linked debt)}}{\text{Net debt}}$	The alternative version of FFO/Net debt recognises the full interest charge for interest linked debt (rather than the cash interest charge in the standard version).
Dividend yield	$\frac{\text{Dividends declared}}{\text{Equity component of the RCV}}$	Dividend yield is a measure of the cash return to shareholders as a percentage of their holding. It forms part of the total return to shareholders along with their share of inflationary growth of the RCV.
Dividend cover	$\frac{\text{Profit after tax}}{\text{Dividends declared}}$	Dividend cover measures a company's capacity to pay dividends at current levels. Profit after tax is defined as funds from operations (post interest) less tax charge.
Retained cash flow (RCF)/Net Debt	$\frac{\text{FFO(post interest)} - \text{dividends paid}}{\text{Net debt}}$	RCF/Net debt measures a company's debt burden relative to their operational income after paying interest and dividends.
Return on capital employed (RoCE)	$\frac{\text{EBIT} - \text{tax}}{\text{RCV}}$	RoCE can be compared against the allowed return on capital. It presents the returns made by the providers of both debt and equity finance.
Return on regulatory equity (RoRE)	$\frac{\text{EBIT} - \text{tax} - (\text{cost of debt} * \text{net debt})}{\text{equity component of the RCV}}$	RoRE measures the return due to shareholders/equity assumed in the notional capital structure. It allows us to assess the returns earned by equity providers against the allowed return on equity.

[185] Notes: Net debt represents borrowings less cash and excludes any pension deficit liabilities.
Funds from operations (FFO) is cash flow from operational activities and excludes movements in working capital.
Cash interest excludes the indexation of index-linked debt.

A number of companies said that the financeability assessment should be based on financial metrics calculated consistently with rating agency methodologies and that guidance from credit rating agencies should represent a floor for target levels of financial ratios. The ratios listed above draw on common approaches used in financial markets and include metrics broadly consistent with those used by the credit rating agencies. The financial ratios we use are not designed to precisely replicate rating agency definitions as we are aware that each credit rating agency has its own definition of these financial metrics.[186] However, in recognition of the role played by credit rating agencies when companies access debt markets, we also consider alternative versions of adjusted interest cover and FFO/net debt. The adjustments broadly replicate the adjustments made by the credit rating agencies.[187] Rating agencies take account of a range of other factors alongside the financial metrics in assessing the credit worthiness of a company, and so the thresholds published for certain ratios are meant as guidance only.

We expect companies to provide commentary explaining how their plans are financeable including on the basis of these metrics and any other factors they consider relevant, both qualitative and quantitative. We will consider the average of each metric over the price control period. We will also look at trends over the price control period, rather than focusing on individual metrics in a single year.

We expect companies to provide board assurance that the business plan is consistent with maintaining the target credit rating on the basis of the notional capital structure. We expect companies to provide evidence of the steps taken by their board in giving that assurance.

8.6 Addressing financeability constraints

Where a company addresses a financeability constraint that arises under the notional financial structure, we expect its business plan to show that:

- the underlying cause of the constraint has been identified;
- all appropriate factors have been taken into account when deciding how best to mitigate those constraints; and
- the approach to addressing the constraint is appropriate, taking account of the effects on customers' bills.

[186] Each credit rating agency has its own definitions for each of its key financial metrics and may make specific adjustments in its assessment of individual company's performance.
[187] The alternative version of adjusted interest cover ratio deducts any surplus pay-as-you-go revenue over operating expenses from funds from operations, broadly recognising the adjustment made by Moody's and Fitch to reflect that such adjustments could improve in-period cash flows. The adjusted FFO/net debt ratio includes the accretion of index-linked debt in the calculation of post interest funds from operations, broadly recognising the adjustment made by S&P.

There is a range of options and market mechanisms available to companies to address financeability constraints where they arise from the notional financial structure. The nature of the constraint may determine the most appropriate mechanism to use.

The level of notional gearing of 55% is applied in the financial model at the start of the period. Where there is significant investment at PR24, gearing may increase materially above the notional level and may lead to a financeability constraint. In such cases, we expect companies to use equity solutions to keep gearing broadly consistent with the notional gearing level across the period. Additional equity may be in the form of retained earnings and, if required, further capital raising.

In our assessment of financeability for the determinations, we may adjust the dividend yield to solve a financeability constraint arising due to real RCV growth. As set out in section 8.2, we will maintain a reasonable minimum level of dividend yield in the financial model and, therefore, we may apply additional equity financing where RCV growth is significant.

As we explain in Chapter 9, companies will need to provide board assurance that the plan is financially resilient based on the actual capital structure. Where a company expects a financeability constraint that could affect its ability to maintain its target credit rating to arise based on its actual company structure, but not the notional structure, it will need to give separate consideration to how it will address the constraint and provide the necessary assurances about its approach.

9. Expectations on financial resilience, dividends, performance related executive pay and voluntary sharing

9.1 Introduction and summary

In this chapter we set out how companies can demonstrate alignment with our expectations on financial resilience, dividends and performance related executive pay in their business plans. We also encourage companies to put forward voluntary sharing mechanisms where these might benefit customers.

Companies have considerable discretion to make decisions about their financing and capital structure arrangements within the boundaries set by the price determination, their licence and company law. Nevertheless, it is important that water companies are able to provide **board assurance** that their business plans are set within the context of maintaining financial resilience in 2025 to 2030 and beyond, supported by relevant evidence.

Water companies provide an essential public service. It is important that companies demonstrate how the decisions they make in declaring and paying dividends and in awarding executive performance related pay take due account of matters that include meeting obligations and delivery for customers, communities and the environment. Therefore, we expect companies to set out how proposed **dividend and performance related executive pay policies for 2025-2030** will ensure company decisions are aligned with what is delivered for customers, communities and the environment. On executive performance related pay, where companies' decisions do not demonstrate that alignment, we are considering further how best to ensure customers' interests are protected.

We also want companies to come forward to **promise their customers a fair share of outperformance**, particularly where, for example, companies outperform areas of the price control package that may not be currently subject to sharing mechanisms (for example, because of outperformance of the cost of debt, high inflation, possible taxation gains or miscalibration of the price determination package).

This chapter is structured as follows:

- responses to the draft methodology (section 9.2);
- board assurance of business plans (section 9.3);
- stress testing business plans (section 9.4);
- incentivising resilient capital structures (section 9.5);
- expectations on dividends (section 9.6);
- expectations on performance related executive pay (section 9.7); and
- voluntary sharing of outperformance (section 9.8).

Further information on topics covered in this chapter, including detailed consideration of responses to our draft methodology, is set out in Appendix 10: Aligning risk and return;[188]

9.1.1 Key messages

- Each company should provide a **board assurance statement** that the actual company is financially resilient over the period 2025-30 and beyond under its business plan. We expect the statement to set out the steps the board has taken to enable it to make that statement, the factors it has taken account of, and the suite of financial metrics used in its assessment. We expect the plan to demonstrate the basis on which the assessment has been carried out, including how the base case and downside scenarios have been established and assessed.
- It is for the board of each company **to identify, assess and manage the principal risks relevant to that company**. We expect companies to draw on these risks to develop scenarios (including combined scenarios) to stress test their business plans when assessing financial resilience. Companies should explain any proposed mitigation measures. We expect the board to consider the risks associated with any potential variance from its business plan. Alongside this we specify a **minimum suite of scenarios that we expect companies to consider and to stress test.**
- In July we consulted on proposals to strengthen the regulatory ring-fence in companies' licences as we are concerned that more needs to be done to protect customers from the risks relating to companies' actual financial arrangements.[189] Our ambition is that these protections will be achieved through the licence and through regular company monitoring. However, we may apply an incentive-based mechanism within the price review if we are not satisfied with progress achieved through other means.
- We expect companies to set out their **proposed dividend policies** for the period 2025-30. We expect companies to be transparent about how dividend policies and dividends paid take account of the guidance we have issued, including that dividends declared or paid take account of company performance in delivering obligations and commitments to customers, communities and the environment, and long term financial resilience.
- We expect companies to set out their **proposed policies for performance-related executive pay** for the period 2025-30. We expect policies to demonstrate clearly a substantial link to stretching performance delivery for customers, communities and the environment and to set out how decisions regarding performance-related executive pay will take into account company performance overall. And we are considering the additional measure of disallowing revenue recovery to ensure that customers are protected if company decisions do not meet expectations.

[188] Ofwat, 'Creating tomorrow, together: Our methodology for PR24, Appendix 10: Aligning risk and return', December 2022.
[189] Ofwat, Consultation under sections 13 and 12 A of the Water Industry Act 1991 on proposed modifications to strengthen the ring-fencing licence conditions of the largest undertakers, July 2022

- We encourage companies to put forward **voluntary sharing mechanisms** where companies or investors receive disproportionate outperformance benefits at customer expense.

9.2 Responses to our draft methodology

Companies generally agreed that they are responsible for their own financial resilience. Most companies agreed that board assurance on financial resilience should be provided alongside business plans, although a few companies were concerned with the overall scale of board assurance required at PR24.

Most companies agreed that the stress testing scenarios we proposed are a good basis for the assessment of financial resilience alongside the bespoke scenarios for each company. However, a number of companies considered that financial resilience can be impacted by the decisions we make in draft and final determinations; those companies argued that they cannot therefore be fully accountable for their financial resilience.

Some companies considered that the PR24 financial model should be used to test financial resilience of the actual company structure to ensure comparability of analysis across the sector.

CCW and many companies either agreed with our expectations for dividends and dividend policies, and performance related executive pay or said that their existing policies are already aligned with our expectations. However, Thames Water and Yorkshire Water considered our expectations on base dividend yield should be net of distributions made to fund inter-company interest that is paid back to the regulated company. CCW strongly supported that non-operational outperformance gained from high inflation ought to be retained or reinvested. However, Thames Water and Yorkshire Water urged caution when considering the benefits of high inflation where real price inflation experienced by companies may be in excess of CPIH or RPI and where investors use infrastructure assets as a hedge against their own inflation linked liabilities.

In relation to performance related executive pay, most companies had no substantive comments on our proposals. One of the listed water companies commented that remuneration targets need to be set dynamically in order to calibrate performance and act as a strong incentive and noted the role that stakeholders play in settling the final arrangements. Another company also noted the need for flexibility and that performance related pay should be able to reward efforts that lead to longer term improvements, as well as the in-year position.

There was a mixed response to our proposals for the voluntary sharing of outperformance. Some companies did not agree with the proposals or with the inclusion of such mechanisms within business plan incentives. Such companies said that we have not identified clear areas where voluntary sharing may be appropriate or that there is a market failure that needs addressing through voluntary sharing. CCW and some companies supported some form of voluntary sharing, with one company suggesting there is scope to go further than our proposals.

We set out our considered response to all of the issues set out above in appendix 10. In section 9.2.1 we summarise the key changes we have made to the proposals in our draft determination.

9.2.1 Key changes from our draft methodology

We confirm that we consider that a base dividend yield of up to 4% is reasonable for companies that have little real RCV growth and that perform in line with their determinations for 2020-2025. This is based on our early view cost of equity and we will update this to reflect the allowed return in our draft and final determination.

We are not satisfied that a number of companies have in the period to date genuinely delivered on our expectations with respect to performance related executive pay by reference to performance for customers, communities and the environment in the round. We set out how we propose to drive further alignment through price review mechanisms at PR24 and beyond.

9.3 Financial resilience and board assurance

We define financial resilience as the extent to which an organisation's financial arrangements enable it to avoid, cope with and recover from disruption, whether that disruption is driven internally or externally to the company.

Company boards are responsible for ensuring their company is financially resilient, under the actual capital structure, over the period 2025-30 and beyond. It is important that each company provides board assurance statements that confirm this in their business plans. We expect the board statements to be supported with evidence that sets out the steps the board has taken to enable it to make that statement and which demonstrates the basis on which the assessment has been carried out.

We expect the board assurance statement and supporting evidence to set out how the base case and downside scenarios have been established and assessed, and the factors considered within the assessment, both quantitative and qualitative. Where a company considers there is a risk to financial resilience, the business plan should set out any mitigating measures or actions that the company plans to take to address this. And we expect companies to set out how they have considered a scenario that considers the potential impacts of our final view of efficient revenue allowances being different from those requested in business plans, along with any mitigation measures the company may take.

Companies should set out the credit ratings targeted for the actual company in their business plans. Where the target credit rating for the actual company differs from that targeted for the notional company structure, the board assurance statement should set out the reasons and provide evidence as to why this is appropriate and in the best interests of customers and the environment.

To support the board assurance statement, companies should set out the key financial ratios for the company assuming it performs in line with its business plan for the actual capital structure and explain how these financial ratios relate to its target credit rating. We have considered whether companies should use the PR24 financial model to prepare forecasts and stress testing under its actual capital structure. However, we expect each company to have its own financial model that incorporates elements of its own capital structure that cannot readily be replicated in a sector-wide model. Business plan tables require companies to populate information about the financial projections for their actual capital structure based on their own assessment and financial projections.

Companies will be expected to demonstrate in their business plans how they will, under a range of potential downside scenarios, continue to finance their operations and planned investments. Companies should explain the steps they intend to take to maintain financial resilience for the duration of the price control and beyond. We set out the approach to stress testing below.

Company boards should also determine the level of assurance required within the business plan to support the statement that the company is financially resilient. The business plans should set out the level of assurance obtained and explain why the board considered the level appropriate, taking account of issues it considers relevant.

9.3.1 Stress testing business plans

Each company should be able to demonstrate that its actual capital structure provides sufficient headroom to enable it to continue to deliver its commitments under a range of stressed conditions.

Companies' business plans should provide their assumptions including the financial ratios relevant to the target credit ratings and to any covenants in place. We expect companies to include their assumptions for totex and the revenue allowance, and to consider other costs and parameters included in their business plan such as interest costs. The base case should be clear, take account of the actual company structure, and clearly explain the assumptions used in setting out the base case, including for example the inflation projections used for the base case.

Business plans should include explanations as to how investment programmes will be financed and show the impact of the investment programme on financial protections. For example, we expect that equity has a role to play in financing material RCV growth especially where a company has a weak financial resilience position. Further to this, companies should explain how the board assured itself that this is the correct base position for the company, based on its specific financing requirements.

Each company remains responsible for determining the downside scenarios that are most relevant for its purposes, drawing links to their own long term viability statements. However, to facilitate comparability in our assessment of company assessments, we prescribe a number of scenarios that we expect companies to assess. For all scenarios, companies should clearly state the proposed mitigations that may be undertaken to address any financial resilience constraint it identifies. We set out the prescribed scenarios, including an expectation that companies carry out reverse stress testing in Appendix 10.

The extent to which a company is able to demonstrate (through its board assurance statement and supporting information) that it (a) will maintain long-term financial resilience and (b) has appropriate mitigating actions under the range of scenarios presented, will form part of the minimum requirements assessed in the Quality and Ambition Assessment (Chapter 11).

9.4 Incentivising resilient capital structures

In the draft methodology, we set out that we considered strengthening the regulatory ring fence and enhancing monitoring and reporting could serve to increase levels of financial headroom and better protect the interests of customers. This may remove the need for specific incentives at PR24 to encourage companies to adopt more resilient financial structures. We also set out that we may apply an incentive-based mechanism within the price review if we are not satisfied with progress in strengthening the regulatory protections, or in circumstances where companies with risky structures are not delivering tangible improvements in financial resilience.

In July we consulted on new proposals to improve financial resilience in the sector.[190] The proposals, designed to strengthen the regulatory ring-fence licence conditions across the sector, included modifications to the credit rating, cash lock up licence conditions and the dividend licence conditions. The proposed changes to the cash lock-up provisions seek to encourage companies to ensure the decisions they make allow them to maintain long term financial resilience, to maintain headroom well within the investment grade and to take early corrective action where it is required, including engaging with us effectively at an earlier stage.

[190] Ofwat, 'Consultation under sections 13 and 12 A of the Water Industry Act 1991 on proposed modifications to strengthen the ring-fencing licence conditions of the largest undertakers', July 2022

In their response to the draft methodology some companies and investors expressed opposition to the proposals to strengthen the regulatory ring fence. All water companies and a number of other stakeholders have subsequently responded to the financial resilience consultation, with a number of companies and investors that responded to the consultation objecting to our proposals.

Our work on these issues remains on-going. Therefore, we maintain the position set out in the draft methodology that we may apply an incentive-based mechanism within the price review if we are not satisfied with progress in strengthening the regulatory protections, or in circumstances where companies with risky structures are not delivering tangible improvements in financial resilience. Should we pursue such an option, we would consult on such a mechanism before, or alongside, our draft determinations.

9.5 Expectations on dividends

It is important that investors in the water sector can achieve a reasonable return on their invested capital, and dividends are an important part of the equity return. However, it is also important that companies explain their dividend policies and dividends paid, and are accountable for their decisions. Companies need to be transparent about how these take account of issues set out in our previously published expectations, including delivery of obligations and commitments to customers, communities and the environment, and long term financial resilience.[191]

Many companies either agreed with our expectations for dividends and dividend policies set out in our draft methodology or said that their existing policies are already aligned with our expectations. One company argued that it did not think it was necessary to provide more prescriptive guidance as autonomy and frequency of dividends attracts equity investment in the sector.

Given companies are providing an essential public service and stakeholder expectations in relation to dividends, we consider setting our expectations for dividend policies over 2025-2030 remains necessary. We set out our expectations for dividend polices covering 2025-30 in full in Appendix 10 – Aligning risk and return.

We expect companies to set out their proposed dividend policy for the period 2025-30 in their business plans. We will assess whether the policies set out in business plans align with our expectations as part of our Quality and Ambition Assessment.

[191] We set out our expectations for dividend policies in Ofwat, 'PR19 final determinations: Aligning risk and return technical appendix', pp. 117-120, section 9.1.4.

Our July 2022 consultation on proposals to strengthen the regulatory ring-fence set out a proposal to modify the dividend policy licence condition.[192] We have not yet published our decision in relation to the consultation, however, our expectations for a reasonable dividend policy that were originally set at PR19 remain the same, and are consistent with the consultation proposals. We expect dividend policies that apply in 2025-30 to align with licence requirements and further guidance we publish as part of our work on the dividend policy licence condition, which we expect to publish alongside our decisions on strengthening the regulatory ring-fence which we expect to publish in early 2023.

Based on our early view of the allowed return in the final methodology, we consider 4% remains a reasonable base dividend yield for the period 2025-30. However, there are a number of reasons why a base dividend yield below 4% may be appropriate for individual companies, such as where companies must fund significant investment programmes, address pension funding concerns or operational issues, or improve financial resilience. Companies should commit in their policies to clearly explain the payment of any dividend, including the base dividend yield, will be by reference to delivery of their obligations and commitments to customers.

In response to our draft methodology, two companies disagreed with our view that the benefits that accrue to equity from the consequences of high inflation (for example where fixed rate debt is in place) should be retained or reinvested by the company and not distributed as outperformance if companies are to meet our expectations. The reasons given for this disagreement were that shareholders may themselves have liabilities linked to inflation.

We clarify that, as the RCV is subject to annual inflation, the value of investors' equity will also grow to a larger or lesser extent depending on the proportion of index linked debt (and other factors including how they manage their costs). Maintaining the dividend yield in line with the dividend policy set out in our expectations means that the absolute dividend received by equity investors will also grow in proportion to the change in equity. Any additional benefits of high inflation to investors will arise through the greater value of equity in the RCV. We therefore maintain our view that retaining or reinvesting the benefit arising from high levels of inflation means that customers benefit through improved resilience of their supplier or through enhanced services.

As set out in Chapter 11, we propose assessing the dividend policies proposed by companies as part of the Quality and Ambition Assessment of business plans.

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[192] Ofwat, Consultation under sections 13 and 12 A of the Water Industry Act 1991 on proposed modifications to strengthen the ring-fencing licence conditions of the largest undertakers, July 2022. The proposal to modify the dividend policy licence condition would require that dividend policies and dividends declared or paid should take account of service delivery for customers and the environment over time, current and future investment needs and financial resilience over the long term.

9.6 Expectations on performance related executive pay

Companies are responsible for setting performance related executive pay and related policies. Nevertheless, we expect such policies and associated decisions to reflect companies' role as monopoly providers of an essential public service, and to take account of the importance placed on this issue by stakeholders in terms of trust and accountability. Our expectations are in line with our board leadership, transparency and governance principles[193] and the objective of demonstrating trust and accountability set out in companies' licences.

Transparency of the relationship between pay and performance is also vital. All stakeholders should be able to clearly see how performance related executive pay is aligned to the delivery of stretching performance for customers and the environment, and how it reflects overall performance, as well as how individual performance metrics are used to determine awards. Accessibility is important if this transparency is to be effective, and in that context, we expect companies to engage with stakeholder feedback.

We expect companies to set out their **proposed policies for performance-related executive pay** for 2025-30 in their business plans. We expect these policies to demonstrate clearly that the criteria for awarding short and long-term performance related elements are substantially linked to stretching delivery for customers, communities and the environment. Policies should also demonstrate how remuneration committees will take appropriate account of company performance overall, and wider compliance issues, as well as performance against specific metrics, when deciding on what, if any, award to make.

We expect that the performance targets used to determine 'stretching' performance in relation to executive pay should be stretching by reference to business plans, and there should be a commitment to update stretching performance to reflect final determinations. Where awards for long-term improvements are being made, such rewards should be structured to appropriately reflect progress.

We recognise that performance related executive pay policies may evolve over time. Nevertheless, companies should also set out how their remuneration committees will ensure there is on-going rigorous challenge in the application of remuneration policies and that targets remain appropriate and stretching throughout the 2025-30 period, taking into account the changing circumstances in which companies operate and stakeholders' expectations.

We set out further detail on our expectations for performance related executive pay policies for the 2025-30 period in Appendix 10 – Aligning risk and return.

In addition to stakeholder responses to our consultation, we note the wider debate regarding water company performance that has taken place, in the UK and Welsh Parliaments and elsewhere, during the course of the consultation period. In the round, we do not consider

[193] Ofwat, 'Board leadership, transparency and governance – principles', January 2019 (updated July 2019.)

that remuneration committees have genuinely embraced the challenge set at PR19 and this is evident in stakeholder responses to the decisions made for 2021-22.

In order to underscore our expectations with respect to performance related pay awards, including the exercise of judgement by remuneration committees with respect to overall performance delivery, we are considering the introduction of a new end-of-period reconciliation mechanism. This mechanism would apply for the remainder of the 2020-25 period (including 2022-23), at PR24, as well as for 2025-30 at PR29, and would allow us to adjust revenue allowances, so that customers no longer fund such awards, if companies are unable to demonstrate their decisions reflect our expectations, including by reference to overall performance.

We will engage with the sector and wider stakeholders on the implementation of this mechanism and expect companies to respond promptly to meet these expectations through their policies and the decisions that are made.

As set out in Chapter 11, we will assess the performance related executive pay policies proposed by companies as part of the Quality and Ambition Assessment of business plans.

9.7 Voluntary sharing of outperformance

Many areas of the price control package are subject to incentive mechanisms (for example totex and performance commitments) such that the interests of investors and customers are aligned. However, there are other areas of the price setting process that may not be subject to sharing mechanisms and where companies and their investors could benefit, for example, because of outperformance of the cost of debt, high inflation, possible taxation gains not covered by reconciliation mechanisms or miscalibration of the price determination package. Therefore, we encourage companies to come forward to commit to share such outperformance with customers on a voluntary basis.

At PR19, a number of companies proposed arrangements that were referenced in our final determinations, including for example the WaterShare+ scheme introduced by South West Water[194] and commitments made by United Utilities to its Community Share scheme.[195] We encourage companies to put forward voluntary sharing arrangements at PR24 which we will

[194] South West Water, 'WaterShare+, sharing our success'. WaterShare+ is designed to give customers a greater say in how the company is run and provides financial benefits to customers where South West Water outperforms its business plan. South West Water set out in its business plan for 2020-25 that this includes net financing outperformance relating to debt raised in previous regulatory periods.

[195] United Utilities proposed £71 million of its own money over the price control period for its CommUnity Share. This was a guaranteed shared amount before considering any dividend payments to provide financial assistance schemes for customers in need of financial support. Where dividend distributions to shareholders exceeded a pre-defined limit, United Utilities committed to match these with contributions to its CommUnity Share scheme.

assess as part of the ambition assessment of the Quality and Ambition Assessment, as set out in Chapter 11.

In responses to the draft methodology, some companies did not agree with voluntary sharing of outperformance or with the inclusion of such mechanisms within business plan incentives. Another company suggested that we could go further, potentially extending the cap and collar on ODI out/underperformance to all sources of out/underperformance, whilst a further company suggested we should consider the capacity of a company to outperform the final determinations in the round rather than at a measure specific level.

We recognise there are potential advantages of a mechanism that extends to all sources of out/under performance. However, we consider that such a mechanism may reduce cost/service incentives at the margin. It could also blunten the incentives, and the clear allocation of risk, associated with company financing choices.

Some companies considered that all forms of voluntary sharing should be given credit in our assessment of business plans to avoid any risk that companies close existing schemes and create new schemes specifically to fit with our criteria. We are open to consider all proposals put forward in business plans that companies can demonstrate represent genuine value for customers.

Finally, we consider there is a distinction between outperformance that is related to operational performance and subject to incentive mechanisms, for example through cost efficiency or delivery against performance commitments, and outperformance that occurs through the examples listed above. We consider it is reasonable therefore to recognise steps companies take to put forward voluntary sharing mechanisms in the ambition assessment of the Quality and Assurance Assessment in company business plans.

10. Companies' PR24 submissions

10.1 Introduction and summary

At PR24 we want the sector to deliver for the long term, delivering greater environmental and social value, reflecting a clearer understanding of customers and communities, and driving improvements through efficiency and innovation. This chapter sets out some specific expectations for company price review submissions, principally the business plans including the long-term strategies and the business plan data tables.

It covers:

- company business plans and narratives (section 10.3);
- long-term delivery strategies (section 10.4);
- the supporting data tables (section 10.5);
- early data submissions (section 10.6);
- approach to new appointees (section 10.7);
- approach to social tariffs (section 10.8);
- assurance and governance expectations (section 10.9); and
- our proposed approach to reconciling past performance (section 10.10).

Our expectations for assurance and governance and our requirement for companies to account for their past performance in the context of their business plan proposals link to our aims in Chapter 11, where we describe how we intend to use business plan incentives at PR24.

10.1.1 Key messages

We expect companies to produce submissions that are convincing, clear, easy to navigate and to the point. Evidence should be relevant and proportionate.

We have refined our guidance to help companies producing submissions:

- The table formats follow equivalent APR tables as far as is possible,
- Table definitions have been drafted in a style which follows that found in RAG4 of the APR guidance.
- We have specified limits for document size and number to ensure the focus is on all the important issues raised.

We set out our expectations for:

- board assurance of specific aspects of the PR24 submission which should be provided as part of an overall assurance statement; and
- evidence of how current and past performance supports credible delivery of the proposals included in each company's plan.

10.2 Responses to our draft methodology

Companies are broadly supportive of the proposals, noting that for table line definitions and commentaries, more detail will be released as part of the final methodology.

One company disagreed that 25MB was a suitable file size limit, particularly for the main plan and considered that a higher limit was more appropriate. A number of companies questioned what counted towards the overall document limits, in particular excel financial models and the 12 standard commentary documents.

Whilst most companies agreed with our expectations for company board assurance and governance one company disagreed, saying that our expectations were too prescriptive and take the autonomy away from companies and their boards.

10.2.1 Key changes from our draft methodology

- We increase the file size limit to 30MB from 25MB.
- We confirm that the financial models and the 12 commentary documents will not count towards the document limits.

10.3 Expectations for company business plans and narratives

Chapter 11 and Appendix 12 detail how we incentivise companies to submit the best possible business plans. The Quality and Ambition Assessment will consider data, information and assurance; costs; outcomes; long term delivery strategies; customer affordability and acceptability; and risk and return.

Overall, it is for companies to decide the best way to present their proposals. But we do expect companies' business plans to adopt some common structure. Reflecting on our experience of PR19, we are introducing some restrictions and standard formats to provide clarity and transparency for stakeholders. We expect plans to be more focused, and accessible and easier to navigate than in PR19. This section provides some further specific requirements that we want companies to follow when submitting their business plans.

We expect submissions to include all the relevant data and information as requested in our methodology and business plan tables, and to be consistent, accurate and assured. The evidence companies provide in their business plans about how they have assured themselves that data is consistent and accurate, and the process their boards have followed to challenge management to deliver a high-quality plan, should be provided with the objective of enabling us to have confidence in the plans. Section 10.9 provides further details of our expectations around assurance and governance.

We expect companies to publish all documents on their websites[196] at the same time as they submit them to Ofwat.[197]

In terms of submission content, we require that:

- submissions will contain a convincing main business plan narrative in a single document that explains succinctly the company's proposals and summarises how the company will deliver our key PR24 ambitions – limited to 200 pages for water only companies and 300 pages for water and sewerage companies;
- companies should provide a guide to reading the plan which contains hyperlinks to all documents;
- companies should clearly cross reference between commentaries, tables and the business plan main narrative;
- companies should provide clear, succinct commentaries (in 12 separate pdf documents corresponding to the table groupings) to accompany individual business plan tables, avoiding duplication of text elsewhere in the plan and including appropriate cross references;
- there should be an overall limit to the number of documents in the submission; 80 for WaSCs and 50 for WoCs. The 12 table commentary documents and the Long-term delivery strategy documents are in addition to these limits;
- there should be a limit of 30MB for each document submitted[198];
- companies should use a searchable pdf format for most documents except for our table templates (duplicate documents in MS word are not required) and supporting excel files that may be submitted;[199]
- each document should use a filename with the OFWAT company acronym and a 2 digit numerical reference – eg "TMS27"; and
- submissions should not contain any video files.

[196] If a company considers some information should not be published – because it is commercially sensitive information, for example – then the company will need to provide its stakeholders and us with strong, robust reasons that are specific to the information concerned.
[197] Companies who choose to submit their plans early can publish their plans when they wish but must do so no later than our deadline.
[198] Companies should pay due attention as to the file size of graphics and photographs included in documents as this can often increase the amount data required for each document.
[199] We will continue with our approach of publishing financial models and supporting feeder models, to promote transparency and understanding of our decision making.

10.4 Long-term delivery strategies

Companies should set out their five-year business plans in the context of a 25-year long-term delivery strategy. This will help ensure that what is delivered in the short term is likely to maximise long-term value for customers, communities and the environment.

Our final guidance on long-term delivery strategies outlines our requirements for what companies should include in their strategies at PR24.[200] This includes:

- setting out the company's long-term ambition to 2050;
- testing how the ambition could be met in different future scenarios, including each of the common reference scenarios, and wider uncertainty testing where appropriate;
- using this testing to present an adaptive strategy for key enhancement activities – including a core pathway of low-regret investment, and alternative pathways, which could be triggered depending on how future uncertainties develop;
- identifying clear decision and trigger points, supported by a monitoring plan;
- setting out the key assumptions and uncertainties that underpin the strategy; and
- providing a holistic narrative on how the company expects to meet its long-term ambition, including its approach to maintaining and improving existing assets as part of base activities.

Most respondents to our draft methodology supported the introduction of long-term delivery strategies. Northumbrian Water argued our guidance was overly prescriptive and restricted innovation in how companies develop their strategies. We consider detailed guidance is necessary to facilitate, among other things, a significant shift towards long-term adaptive planning in the sector. It also enables a level of standardisation that allows us to meaningfully take the strategies into account in our decisions.[201] Companies may go further than our requirements, for example to reflect their specific circumstances. Northumbrian Water and Wessex Water raised the issue of how our business plan interventions would be reflected in the strategy. We expect companies to reflect any interventions we make in future long-term delivery strategies.

Some stakeholders commented that strategies should reflect base expenditure. We consider that companies should include base requirements by providing a clear narrative on how their approach to base, as well as enhancement, activities will contribute to long-term outcomes.[202] This includes understanding long-term risks from asset failure and deterioration, and explaining how these will be effectively managed. Companies should also forecast stretching long-term performance improvements from base expenditure. However,

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[200] Ofwat, 'PR24 and beyond: Final guidance on long-term delivery strategies', April 2022.
[201] See Appendix 14, 'Impact assessments.'
[202] As set out in Ofwat, 'PR24 and beyond: Final guidance on long-term delivery strategies', April 2022, p. 16.

we continue to consider that adaptive pathways should focus on enhancement requirements, for the reasons set out in our guidance.[203]

We consider feedback from companies on the impact of long-term delivery strategies on setting enhancement expenditure allowances in the respective appendix.[204]

We expect the long-term delivery strategy to be fully consistent with the PR24 business plan. Across the PR24 submission, the company should present a single adaptive strategy, rather than multiple alternate plans. The strategy should be no more than 100 pages for water-only companies and 150 pages for water and sewerage companies. It should include an adaptive pathway diagram, clearly showing how, when, and under what circumstances each pathway diverges from one another, as well as the associated decision points.

In January and February 2023, we will provide an opportunity for companies to receive high-level feedback on the development of their long-term delivery strategy. Our feedback will focus on the development of strategies in line with our guidance.

10.5 The supporting data tables

We will use Excel templates for the business plan tables as we did at PR19. We have learnt from PR19 to make improvements to the process, including:

- Ensuring that a significant proportion of the table formats closely mirror their annual performance report (APR) equivalents (with line definitions clearly cross-referenced). We expect that this will reduce the number of queries from companies as they should be familiar with the requirements for those tables.
- Grouping the tables into subject areas, each having their own guidance document for completing the tables which follows the regulatory accounting guidelines (RAGs) style. We will similarly expect companies' table commentary documents to be grouped in this way.
- Having a process for companies to raise queries on the business plan requirements, but we will impose strict deadlines for companies' queries.

As we developed the data tables for PR24 we grouped tables into 3 development 'batches' in order to deal with them in a sensible and efficient manner. We completed the tables that closely matched the APR tables as 'batch 1' and identified tables that were likely to require later changes as 'batch 3'. All other tables are 'batch 2'.

We have not included all formulae in the Excel batch 3 tables. The supporting guidance documents set out the approach for calculated cells.

[203] Ofwat, 'PR24 and beyond: Final guidance on long-term delivery strategies', April 2022, p. 48.
[204] See Appendix 9, 'Setting expenditure allowances', pp. 80-82.

We will provide a process for companies to query the definitions at a detailed, working level in early 2023. Initially this will only be for tables in batches 1 and 2. We will release a further version of the tables after this first round of queries in February 2023.

10.6 Early data submissions

In IN 22/01 – Expectations for monopoly company annual reporting 2021-22 (March 2022) we outlined further information that would be requested outside of the APR and the business plan that would be used to develop our policies for PR24. For asset health, we set out our proposals to explore and test wider measures associated with the health and performance of water and wastewater assets in our recent Operational resilience discussion paper.[205]

We set out progress made on the further information requested from companies below.

Table 10.1: Progress made in relation to early data submissions

<table>
<tr><th>Policy area</th><th>Progress</th></tr>
<tr><td>Enhancement cost reporting</td><td>The data submitted by incumbent companies will be used to set efficient enhancement allowances at PR24. We will consider what information we want to receive alongside the 2022-23 annual performance report in early 2023.</td></tr>
<tr><td>Bioresources</td><td rowspan="2">Data submitted by companies was included in PR24 cost assessment datasets that we published in October 2022.[206] The published datasets will be used by Ofwat and incumbent companies to develop econometric cost models that can be used to set efficient expenditure allowances at PR24. We will consider what information we want to receive alongside the 2022-23 annual performance report in early 2023.</td></tr>
<tr><td>Base costs</td></tr>
<tr><td>Developer services</td><td>We have used the 2021-22 developer services data provided by incumbent companies to inform our approach to regulating developer services at PR24. We intend to request the same data again for the 2022-23 reporting year in early 2023.</td></tr>
<tr><td>Leakage</td><td>We are currently analysing the data received. We aim to use the information to inform our assessment of leakage expenditure, and setting leakage performance commitment levels, at PR24. We will identify the elements of this data we will require companies to provide for the 2022-23 reporting year and forecast for the business plan tables in early 2023.</td></tr>
<tr><td>Common PCs</td><td>We expected to ask for data related to new common performance commitments. However, we understand that data is already in the public domain for all new performance commitments except biodiversity. And for the latter companies cannot report changes in biodiversity until four years after they have first surveyed sites.
We will aim to check our understanding of company historical performance against all performance commitments in the first half of 2023.[207]
In our consultation on the Regulatory Accounting Guidelines (RAGs) in early 2023, we expect to consult on annual reporting of GHG emissions, with a view to expanding our core reporting requirements.</td></tr>
</table>

As set out in chapter 5, companies should provide an early submission for bespoke performance commitments by 14 April 2023 and we will provide feedback in July 2023. This is

[205] Ofwat. 'Operational resilience discussion paper', April 2022.
[206] Ofwat, 'PR24 – Cost assessment datasets', October 2022.
[207] In December 2022 we asked companies to review the historical data trends for PR24 performance commitments that have a comparable existing PR19 performance commitment.

to enable companies to take account of feedback on their draft definitions and include fully developed proposals for any bespoke performance commitments in their business plan submissions.

10.7 Approach to new appointees

The new appointments and variations (NAV) framework enables new entrant companies (new appointees) to replace an existing company (incumbent) as the provider of water and/or wastewater services in a specific geographical area in England and Wales.

We seek to ensure that our regulation of, and interactions with, new appointees are proportionate to the risks to customers and size of new appointees. In practice this means that we have not conducted price controls for new appointees and do not propose to do so as part of PR24. Instead, each new appointee's licence (Condition B) includes a relative charge control, which prevents the new appointee from levying charges that are higher than the incumbent water company that was responsible previously for its area. As a consequence, we do not require new appointees to submit business plans or supporting business plan data tables.

10.8 Approach to social tariffs

The UK and Welsh governments are considering the role for, and potential form of, a single water affordability discount scheme for the water and wastewater sector, following on from the recommendation made by CCW in its independent water affordability review. Any resulting scheme may be introduced for or during 2025-30. To better fit in with the timing of the sector's work on this, we plan to specify requirements for social tariffs in companies' business plans alongside the PR24 batch 3 data tables. We set out the likely scope of these requirements, and reporting on wider support for customers struggling to pay, in section 3 of Appendix 1 – Affordability].

10.9 Assurance and governance expectations

Good assurance and governance of PR24 submissions is vital if stakeholders, including Ofwat, are to have confidence in the information presented in them. The submission can only be of high quality where there are **assurance** checks on the systems and processes for developing the business plan, the production of the data and information and when stakeholders have confidence that a company's full board has been integral to the **governance** surrounding the submission.

It is for the companies and their boards to determine the role that assurance plays in this process, including the role of external assurance. We expect company boards to own and be accountable for their submissions and the business planning processes that underpin all aspects of the plan.

Board governance

We expect the board to consider how it satisfied itself that the **systems, approach to risk management, and internal controls and processes** in place to develop the data and information on which it based its decisions was appropriate and effective. The board should be confident that the overall strategy for data assurance and governance processes delivers high-quality data across all aspects of the plan and long-term delivery strategy. It should be confident that it had access to a complete and transparent view of the company's historic and expected performance when making decisions and that it is satisfied that all the elements add up to a submission that is high quality in the round.

The company's board should challenge and demonstrate how it has satisfied itself that its submission will deliver operational, financial and corporate resilience[208] over the next control period and long term. This includes a clear responsibility for the company's Board to ensure and explain in its overall assurance statement that the company's business plan is deliverable and will enable the company to meet its statutory and licence obligations, now and in the future.

The board should also be involved with the testing of assumptions that underpin the submission. It should be fully aware of the impact that alternative assumptions may have. In particular, we expect that the range of skills and experiences from the whole board be used to test the impact of the assumptions on the wider stakeholder base.

We would expect the boards of each company in Wales to satisfy itself that the long-term strategies take into account the outputs of the **collaborative approach**[209], as well as what is learnt from wider stakeholder and customer engagement.

Specific areas of assurance of plans by company Boards

Our expectations for board assurance of specific aspects of the PR24 submission are set out in Table 10.2. These should be provided as part of an overall **assurance statement** by each company's full board.

[208] We define corporate resilience as the ability of an organisation's governance, accountability and assurance processes to help avoid, cope with and recover from, disruption; and to anticipate trends and variability in its business operations.
[209] The collaborative approach in Wales is explained in section 4.5 of Chapter 4.

Table 10.2 Board assurance requirements

Area	Board assurance requirements
Long-term delivery strategies	That the board has challenged and satisfied itself that the long-term delivery strategy: • reflects a long-term vision and ambition that is shared by the board and company management; • is high quality, and represents the best possible strategy to efficiently deliver its stated long-term objectives, given future uncertainties; • will enable the company to meetits statutory and licence obligations, now and in the future • is based on adaptive planning principles; • has been informed by customer engagement; and • has taken steps to secure long-term affordability and fairness between current and future customers. That the board has challenged and satisfied itself that the 2025-30 business plan implements the first five years of the long-term delivery strategy. The board should provide evidence of where it has challenged company management and an explanation of the process it has used to arrive at the view that its strategy is the best it can be.
Affordability	That the board has challenged and satisfied itself that: • the full implication of the 2025-30 business plan for customers was considered and that the plan achieves value for money; and • the long-term delivery strategy protects customers' ability to pay their water bill over the long term and delivers fairness between what existing customers will pay and what is paid for by future customers.

Costs and outcomes	That the board has challenged and satisfied itself that:
	• the performance commitment levels in the plan are stretching but achievable and reflect performance improvements expected from both base and enhancement expenditure;
	• the expenditure forecasts included in the company's business plan are robust and efficient;
	• the needs for enhancement investment are not influenced by non-compliance or non-delivery of programmes of work (both base and enhancement) that customers have already funded;
	• the options proposed within the business plan are the best option for customers and a proper appraisal of options has taken place;
	• PR24 plans and the expenditure proposals within them are deliverable and that the company has put in place measures to ensure that they can be delivered. This includes setting out the steps the Board has taken to satisfy itself that supply chain risk is manageable and delivery plans account for:
	  o the ability of the company and its supply chain to expand its capacity and capability at the rate required to deliver the increased investment;
	  o the impact of similar levels of growth across the sector and any overall sector and supply chain capacity constraints; and
	  o key supply chain risks and capacity constraints, such as the availability of specialist resource or components, e.g. river quality monitors, smart meters or SuDS designers.
	• the plan includes price control deliverables covering the benefits of material enhancement expenditure (not covered by performance commitments);
	• that the expenditure proposals are affordable by customers and do not raise bills higher than necessary; and

	• the expenditure proposals reflect customer views, and where appropriate are supported by customers.
Risk & return	**Financeability** That the board should: • provide assurance that the business plan is financeable on the basis of the notional capital structure. This assurance should take account of all components of the business plan, including our early view on the allowed return on capital for PR24 that we set out in Chapter 7, and consistent with maintaining target credit ratings at least two notches above the minimum of the investment grade. We expect the board to set out clearly the steps taken to provide assurance, including the consideration of the financial ratios. See Chapter 8 for further details. • set out clearly the steps taken to provide assurance, including the consideration of the financial ratios. See Chapter 8 for further details. **Financial resilience** That the board should: • provide an assurance statement that the actual company is financially resilient over the 2025-2030 period and beyond under its business plan; and • set out the steps it has taken to enable it to make that statement, the factors it has taken account of, and the suite of financial metrics used to ensure the company is financially resilient. We expect the plan to demonstrate the basis on which the assessment has been carried out, including how the base case and downside scenarios have been established and assessed. See Chapter 9 for further details.
Customer engagement	That the board should provide assurance that the company's customer engagement and research meets the standards for high-quality research and any other relevant statements of best practice and has been used to inform its business plan and long-term delivery strategy.

10.10 Reconciliation of past performance

At PR24 we will need to reconcile companies' 2020-2025 performance against the PR19 final determination. This requires us to assess company reported costs and performance for 2020-2025 and ensure we adjust company revenue and RCV appropriately against the incentive mechanisms and reconciliation true ups included in the PR19 final determination. We will also need to:

- reconcile a small number of additional reconciliation models that will apply for those companies that received Green Recovery funding in July 2021; and
- take into account some elements of the 2019-20 Blind year[210] adjustments, which were not accounted for at PR19 or during 2020-2025.

We provide further information on the reconciliation models, how they operate and how adjustments will be applied in Appendix 13 - Data and modelling. The appendix also confirms

210 The blind year refers to the final year of the control period, where actual performance data is not available until after we set final determination for a price review. At PR19 we used forecast performance for 2019-20. We then calculated and we published the difference between the forecast and actual performance in 2020.

which of the 2019-2020 blind year adjustments will be made as part of PR24 and which were made during 2020-2025.

In making these reconciliations at PR24, we confirm the following in relation to:

- how we will apply past performance reconciliation adjustments to 2025-2030 price controls;
- making 2024-2025 blind year adjustments; and
- business plan submission expectations for past performance.

How we will apply past performance reconciliation adjustments to 2025-2030 price controls

When we make adjustments to 2025-2030 price controls for past performance, we will:

- apply each adjustment in the appropriate control (as specified in the rulebook for each reconciliation) and consider over what period each should be applied; and
- apply RCV adjustments as midnight adjustments on 1 April 2025.

For water trading incentives revenue adjustments, companies will need to allocate the incentive payments from new water trades in the 2020-2025 period between the water resources and network plus water revenue controls. We expect companies to set out their approach for allocating incentive payments which we will review.

Consistent with previous price reviews, at PR24 we will:

- Retain the flexibility to apply revenue adjustments either in the first year or spread over a number of years in the new price control period (preserving the net present value of the reward or penalty due).
- Expect companies to make any specific proposals, providing evidence that they have considered the impact of their proposals on customers both now and in the longer term and evidence of customer views on the chosen bill profile.
- Apply revenue adjustments to the controls after financeability has been assessed. This is to ensure incentives for companies are not diluted and customers do not compensate companies for prior poor performance.

Making 2024-2025 blind year adjustments

In the same way that we had to adjust revenue and RCV to reflect 2019-2020 blind year performance, we will also need to adjust for 2024-2025 blind year performance.

We will use a similar process for making 2024-2025 blind year adjustments to the one used for 2019-2020 blind year adjustments. This means that we will:

- include an adjustment factor within the RFI formula that will be set out in the formal notification letters at PR24 final determination;
- calculate the required 2024-2025 blind year revenue and RCV adjustments in 2025-2026; and
- allow companies to recover defined elements of the 2024-2025 blind year revenue adjustments during the 2025-2030 control period. Companies will have the flexibility to decide the proportion of the 2024-2025 blind year adjustments recovered in each of the remaining years of 2025-2030, but we will expect them to do so in a way that is demonstrably in customers' best interests (see Chapter 3 for further details of the RFI and this process).

In the PR19 Reconciliation Rulebook we said that, for in period ODIs only, we would not set revenues for 2025-2030 at PR24 using forecast performance in 2024-2025[211]. We said we would make any subsequent blind year adjustment for in-period ODIs using the in-period adjustments model to inform our in-period determination in late 2025, adjusting allowed revenues in 2026-2027. We have considered whether this remains the most appropriate approach or whether we should continue to include forecast data for all 2024-2025 ODIs as we did at PR19. We remain open to amending the approach set out in the PR19 Reconciliation Rulebook for in period ODIs. We will set out our final approach by draft determination. Regardless, we require companies to provide forecast performance against 2024-2025 performance commitments in the business plan for our information.

10.11 Business plan submission expectations for past performance

Accounting for past performance

We would expect companies and their boards to carefully consider how their performance during 2020-2025 should inform their proposals for 2025-2030 and beyond. While the price review reconciles differences in a company's actual performance compared to its final determination and makes revenue and RCV adjustments, we would expect companies to look beyond the financial impact.

For example, we would expect companies to want to understand how their performance affects customers and the environment and to be able to demonstrate how their understanding of the drivers of good and poor performance informed their business plan proposals. Details of our approach to setting performance expectations and funding service enhancements are set out in chapters 5 and 6.

[211] In period ODI payments covering reported performance for 2022-2023 will be determined by 15 November 2023, to take effect in customer bills in April 2024. Any ODI payments due for 2023-2024 reported performance will be determined as part of our PR24 final determination.

We expect each company's business plan submission to draw on this and set out:

- how its current and past performance supports credible delivery of the proposals included in its plan; and
- for any gaps between the company's track record of performance, including delivering improvements, and its proposals, how it intends to apply lessons learnt to successfully deliver the plan it proposes.

We expect plans to deliver for all stakeholders and support the credibility of the sector overall. Consequently, when demonstrating their track record of performance in relation to their business plan proposals, companies should consider feedback from Ofwat and key stakeholders such as the Environment Agency or Natural Resources Wales, the Drinking Water Inspectorate and CCW. Specifically, we expect companies to refer to:

- overall categorisations in annual reports[212];
- performance against the performance commitments and cost allowances; and
- enforcement of any statutory and licence obligations.

The amount of evidence expected from each company will be proportionate to the extent of the gap between its track record of performance and business plan proposals.

Requests for interventions on PR19 reconciliation models

At previous price reviews, when submitting past performance information in business plans, some companies have asked us to intervene on the operation of individual reconciliation models.

Our expectation is that companies should not be seeking to override or amend the adjustments that flow from the PR19 reconciliation models. The policy and decisions that the mechanisms are designed to enact and the basis of any opportunity for interventions are set out in the final determination; companies are subject to the package of risks and incentives for the 2020-25 period. For example, in the PR19 final determination, we said that companies could make a case for an intervention on penalty payments incurred under the RFI, where they related to variance in developer services revenue.

The detailed operation of the reconciliation models is confirmed through the Rulebook, first published in 2021 following consultation. In many cases companies had sight of how the models would operate earlier in the PR19 process.

The Covid 19 pandemic is an exception where we indicated that we may intervene or a company might make a request for an intervention where there has been a material impact. In 2021, we considered that there was only one area, Per Capita Consumption (PCC), where

[212] Ofwat's annual service delivery report; the Environment Agency's Environmental Performance Assessment; and CCW's Household Customer Complaints Report.

we needed to intervene and a small number of areas where specific additional reporting guidance for all companies was necessary. This is because there is a high bar for any adjustments to performance commitments and ODIs, particularly where comparison across the sector demonstrates there is scope for flexible and effective delivery. We explained our approach to PCC in, 'Consultation on changes to per capita consumption performance commitments – our decision on reporting performance and ODI timing', November 2021. We describe the expectations in relation to Covid-19 impact in more detail in Ofwat, 'IN 21/01 Expectations for monopoly company annual performance reporting 2020/21', April 2021. We also provided an update of our position in light of company reporting in their annual performance reports to date. In Sector overview: Final determinations of in-period outcome delivery incentives for 2021-22 we said that "the absence of [this] evidence, combined with the service failures customers experienced during 2022 driven by prolonged hot and dry weather, reinforce the need for companies to have the strongest possible incentives. Companies that don't meet their 2020-25 performance commitment levels should expect to incur underperformance payments."

Additionally, in the joint 17 October 2022 letter Supporting customers through cost of living pressures, Ofwat and CCW set out an expectation that all companies should do more to support a greater number of customers through the cost of living crisis.

Some of our conversations with companies on this issue, identified the potential interaction between the penalty within the RFI mechanism and actions a company might take to defer the collection of a proportion of its allowed revenue to help manage short term bill impacts for customers as a potential barrier to taking action.

The rules of the RFI mechanism (as set out in the PR19 FD and PR19 reconciliation rulebook) do not allow companies to exclude the impact of deferring revenue for bill smoothing from the calculation of any RFI penalty in any given year. Nor do they explicitly allow companies to make a case for its exclusion at PR24 as part of the wider reconciliation process to be undertaken.

We do not want the operation of the RFI to be a barrier to companies choosing to help customers in the current circumstances. Consequently, we would not intend to apply a RFI penalty in part or in full, where it relates to a company taking positive steps to defer revenue to support customers.

We would expect a company to apply the RFI mechanism as normal in period. But where a penalty is due under the operation of the mechanism a company should set out, as part of its price review submissions, what proportion of the calculated penalty is demonstrably due to its actions to defer allowed revenue. In light of the information provided, we will then intervene to adjust all or part of the penalty.

Feeder models for 2019-2020 blind year and PR19 reconciliation models

We will use two feeder models to take the outputs from the 2019-2020 blind year and PR19 reconciliations and convert them for use in the financial model. These are the revenue adjustments model and RCV adjustments model.

The first will profile the revenue adjustments in the 2025-2030 price controls and direct the profiled revenue adjustments to the right price control in the financial model. The second will direct the RCV adjustments from the reconciliations into the right price controls. We set out further details of our expectations on business plan tables for past performance in Appendix 13 – Data and Modelling. We also expect companies to publish their populated PR19 reconciliation models.

11. Quality and ambition assessment

11.1 Introduction and summary

The sector needs to confront major challenges in the coming years. Companies' PR24 business plans will play an important role in this process, by demonstrating how they will meet these challenges, the levels of performance they will deliver and associated costs. We will use the information revealed in the best business plans to significantly push forward the performance of the sector for the benefit of customers, communities and the environment.

Our goal is for companies to provide PR24 plans that include stretching levels of service at efficient cost which will deliver affordable wider value for customers, communities and the environment. Companies also need to provide us with the information we need to conduct the price review efficiently and effectively. To encourage companies to achieve this, we will:

- conduct a quality and ambition assessment (QAA) on their business plans; and
- apply strong reputational, financial and procedural rewards and penalties dependent on their performance in this assessment.

This chapter sets out:

- an overview of stakeholder responses to our draft methodology proposals for our assessment of company business plans and associated incentives;
- key policy changes from draft methodology; and
- our final methodology policy on the QAA and associated rewards and penalties to support the sector to transform its performance.

We provide further details on stakeholders' responses, our consideration of these and the reasons for our policy decisions in Appendix 12 – Quality and ambition assessment.

11.1.1 Key messages

Our approach will:

- encourage companies to submit quality and ambitious business plans through a combination of **reputational, financial and procedural incentives;**
- **categorise companies** into four categories:
    - Outstanding – sets the bar for others;
    - Standard – generally good;
    - Lacking ambition – improvements required; and
    - Inadequate – significant improvements required.

- **reward** companies that produce ambitious proposals that require limited intervention to deliver for customers, communities and the environment;
- provide the **greatest rewards** for companies that set a new standard for the sector through plans containing significant ambition;
- use **penalties** to ensure all companies are discouraged from providing business plans that fall short on quality or lack the ambition needed to push forward the sector's performance.

We are offering incentives for companies' business plans at PR24 because:

- they **delivered good results for customers, communities and the environment** at PR19 and PR14, when we were able to use the information provided in ambitious plans to challenge the rest of the sector.
- companies providing ambitious plans which are also of sufficient quality can **turn their attention more quickly to delivering outcomes for customers, communities and the environment.** It also means that we can target our attention on driving improvements in the poorest plans.

Our rewards and penalties for the QAA are summarised in Table 11.1 overleaf.

Table 11.1 Summary of company categorisation at PR24

Company categorisation	Business plan characteristics	Return on regulated equity	Protection from reductions	Cost sharing
For companies that pass our quality assessment:				
Outstanding – sets the bar for others	Demonstrates significant ambition.	Financial adjustment equivalent to **+ 30 bps return on regulated equity**	**Protection from reductions** in allowed return on capital and base cost allowances between draft and final determination	**50:50 cost sharing** - Company can recover 50% of cost overspend from customers and can retain 50% of underspend
Standard – generally good	Demonstrates modest ambition.	Financial adjustment equivalent to **0 to + 10 bps return on regulated equity** (each adjustment will be dependent on the ambition demonstrated)	N/A	**50:50 cost sharing** - Company can recover 50% of cost overspend from customers and can retain 50% of underspend
Lacks ambition – improvements required	Demonstrates insufficient ambition.	Financial adjustment up to an equivalent of – **30 bps return on regulated equity**	N/A	**55:45 cost sharing** - company must incur 55% of cost overspend and may only retain 45% of underspend
For companies that fail our quality assessment:				
Inadequate – significant improvements required	Is of insufficient quality.	Financial adjustment equivalent to - **30 bps return on regulated equity**	N/A	**60:40 cost sharing** - Company must incur 60% of cost overspend and may only retain 40% of underspend

The remainder of this chapter covers:

- **responses to our draft methodology** and **key policy changes (Section 11.2)**;
- **our quality and ambition assessment (QAA)**, including the aspects of plans we will incentivise (**Sections 11.3**);
- **the package of reputational, financial and procedural rewards and penalties** we propose to offer to encourage quality and ambitious plans (**Section 11.4**); and
- our expectation for companies to provide **quality and ambitious proposals in their first business plan submission,** including how we will encourage this (**Section 11.5**).

11.2 Responses to our draft methodology

Stakeholder responses to our draft methodology proposals broadly agreed with the principle of a quality and ambition assessment and the scope of each component. But:

- many considered we should take account of past performance to place greater emphasis on the deliverability of companies' proposals – to discourage companies from including ambitious proposals they are unlikely to deliver;
- a small number of companies considered that their ambition should be assessed relative to their outturn position;
- several were concerned that our proposed minimum expectations were too prescriptive and would penalise companies for preparing plans using assumptions that differ from ours; and
- some considered we had not provided sufficient detail on the mechanics of our assessment.

Stakeholders were supportive of using incentives to encourage quality and ambitious plans, however:

- some were concerned that we may be unlikely to award any company with the top categorisation;
- many considered that the use of financial and reputational penalties for companies categorised as lacking ambition or inadequate is inappropriate because it could deter investment;
- some were concerned that we had not been clear enough about how companies should communicate their categorisation to stakeholders;
- a few called for strengthened procedural benefits; and
- a minority considered that companies with strong outturn performance should be rewarded with a less onerous assessment of their business plan.

Finally, some respondents considered that the removal of the IAP phase reduced opportunities for feedback and engagement that were previously provided at PR19. Some stakeholders also raised concerns that we have provided insufficient incentives for companies to improve their proposals after draft determination.

11.2.1 Key changes from our draft methodology

We have carefully considered stakeholder views on our draft methodology proposals for encouraging quality and ambitious plans. We summarise changes from the draft methodology below and provide more information about stakeholder responses and how we have considered them in Appendix 12 – Quality and ambition assessment.

For final methodology, we add a minimum expectation for each company to evidence that it can credibly deliver the proposals in its plan. This minimum expectation will provide Ofwat and other stakeholders with greater confidence that the plan will deliver for customers, communities and the environment and so supports the credibility of the sector overall. The amount of evidence we expect from each company will be proportionate to the extent of the gap between its track record of performance, including delivering improvements, and the proposals in its plan. We provide more information on the evidence we expect from companies in Chapter 10. Consequently, companies with:

- strong outturn performance will find it easier to meet our minimum expectation to demonstrate that their plan is deliverable.
- poorer outturn performance will have more work to do to demonstrate that they can deliver ambitious proposals.

We clarify that when determining the QAA categorisations and associated rewards or penalties we publish at the time of our draft determinations, we will only consider the evidence provided in the first business plan submission and responses to clarification questions.

11.3 A quality and ambition assessment

This section outlines the QAA, which we will use to determine rewards or penalties for PR24 business plans. The QAA is comprised of two components. The first component will consider whether companies' PR24 plans are of sufficient quality and covers a broader range of areas than the second component, in which we will consider the level of ambition they demonstrate. The scope of our QAA and our approach for determining rewards and penalties is summarised in Figures 11.1 and 11.2 below.

Figure 11.1 Scope of PR24 QAA

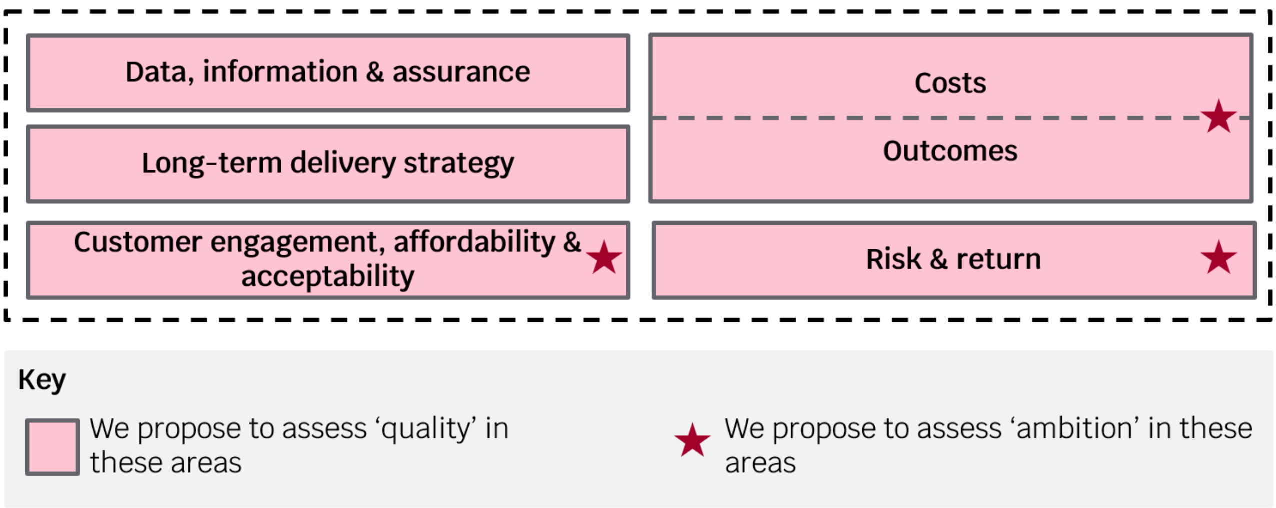
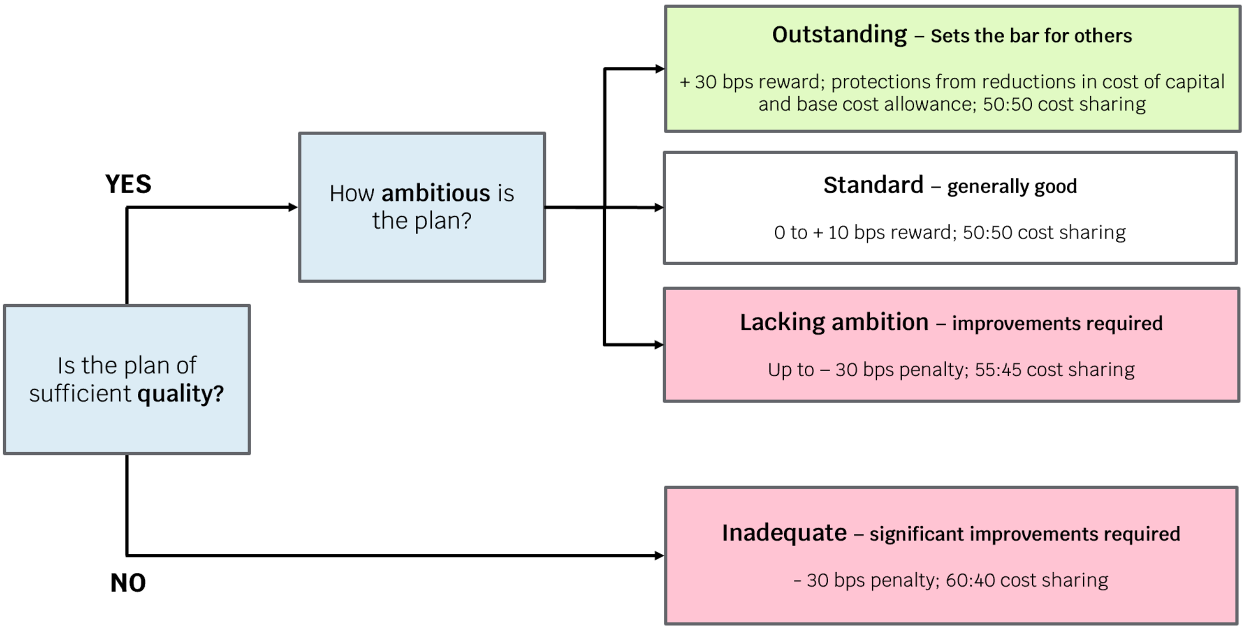


Figure 11.2 Framework for determining QAA rewards and penalties



11.3.1 Quality assessment

It is important that companies provide plans that:

- include the evidence we require and to the standard we require;[213]
- use our assumptions and methodologies or provide evidence to support an alternative; and
- address any feedback that we have provided prior to the business plan submission.

We consider this in our quality assessment, in which we will assess whether plans meet a set of minimum expectations.

We consider that all companies should be able to meet our minimum expectations in the round. Therefore, we do not provide rewards for the quality component of the assessment. It is important that companies submit quality plans at the start of process and so we will penalise companies that fail our minimum expectations of a quality plan. Companies that fail on quality will also be ineligible for rewards in the ambition component of the assessment. Although all companies may have to provide some additional or better evidence or revise elements of their plans, companies that fail on quality assessment will need to make significant changes before we can have confidence in their proposals.

[213] The standard of evidence we require is sufficient and convincing, except where we require a higher bar of compelling evidence.

The areas included in the quality assessment are set out in Figure 11.1 above. We set out below the minimum expectations in each of these areas.

Data, information, and assurance

Here we consider whether companies meet our expectations for the business plan submission.

Table 11.2 Minimum expectations for data, information and assurance

Minimum expectations	References
The plan is accessible and follows a clear structure, meeting our requirements as specified in our guidance, such as page and document limits where specified.	Chapter 10, section 3
The company's PR24 business plan is fully consistent with the long-term delivery strategy and the company presents a single adaptive strategy, rather than multiple alternate plans.	Chapter 10, section 4
The company provides sufficient and convincing evidence to demonstrate how its track record of performance, or lessons learnt from poor performance, support the credible delivery of the proposals in its plan	Chapter 10, section 10
The company's full Board provides an assurance statement that meets our Board assurance requirements as specified in our guidance.	Chapter 10, section 9
The company provides the data and information as requested in our methodology and business plan tables. This data and information is consistent, accurate and assured using effective internal systems, controls and processes.	Chapter 10, section 9

Long-term delivery strategy

Here we consider whether companies have developed their long-term delivery strategies in line with our final guidance.

Table 11.3 Minimum expectations for long-term delivery strategy

Minimum expectations	References
The long-term delivery strategy has been developed in line with our guidance and has taken account of any feedback. This includes: • testing how the company's ambition can be met in different future scenarios, including the common reference scenarios; • using this to set out key enhancement activities in terms of core and alternative adaptive pathways, with appropriate use of trigger and decision points; and • ensuring the strategy is supported by robust evidence, including how base expenditure contributes towards meeting the ambition.	PR24 and beyond: Final guidance on long-term delivery strategies [214]

[214] Ofwat, 'PR24 and-beyond: Final guidance on long-term delivery strategies', April 2022.

Customer engagement, affordability and acceptability

Here we consider whether:

- customer engagement activities meet our standards for research, challenge and assurance;[215] and
- plans consider affordability overall, for current and future customers, and for residential customers who may struggle to pay their bills

Companies must meet the following expectations.

Table 11.4 Minimum expectations for customer engagement, affordability and acceptability

Minimum expectations	References
The company's plan provides sufficient and convincing evidence that its customer engagement activities meet our standards for research, challenge and assurance.	Chapter 4, section 4.4 PR24 and beyond: Customer engagement policy - a position paper [216]
The company's plan explains how it has taken account of views on the affordability of its proposals for all customers, including for those who struggle, or at risk of struggling, to pay their bills.	Chapter 4, section 4.4
The company's business plan and long-term delivery strategy demonstrates that its proposals are likely to be fair and affordable for both current and future customers.	Chapter 4, section 4.4 PR24 and beyond: Final guidance on long-term delivery strategies [214]
The company's plan provides sufficient and convincing evidence that it has followed our guidance for testing customers' views of the affordability and acceptability of its proposals.	Chapter 4, section 4.4
The company's business plan includes plans for supporting customers to pay their bills using social tariffs and other methods. We expect the company to include plans for the two scenarios we specify in our methodology.	Chapter 10, section 8; Appendix 1, section 3.

Costs

Here we consider if business plans and, where relevant, long-term delivery strategies meet our minimum expectations for costs.

[215] We will take account of evidence of customers' views on specific proposals in the relevant quality and ambition assessments across costs, outcomes and risk and return.
[216] Ofwat, 'PR24 and beyond: Customer engagement policy - a position paper', February 2022.

Table 11.5 Minimum expectations for costs

Minimum expectations	References
The business plan sets out the benefits of the company's proposals, specifically: • the performance levels delivered through base for all performance commitments; • impacts of enhancement expenditure on performance commitments for 2025-30 and the longer term (ie to at least 2050); • the primary benefits of its proposals. Wherever appropriate it reflects these benefits in performance commitments and price control deliverables; and • the additional benefits of its proposals. Wherever appropriate it reflects these benefits in performance commitments and price control deliverables.	Chapter 6, sections 5, 6 and 7
The business plan and long-term delivery strategy are consistent with the achievement of statutory requirements and relevant government targets. For Welsh water companies this includes demonstrating how they have taken into account the outputs of the collaborative approach.	Chapter 6, section 6 Chapter 10, section 4
The business plan and long-term delivery strategy include investment options which are consistent with the company's finalised water resources management plan, final WINEP/NEP submission and, if applicable, drainage and wastewater management plan, having adequately addressed any feedback previously provided on these. We expect compelling evidence on the need for variations from final plans, if relevant. We will take into account the reasons for any variations in assessing whether minimum expectations have been met.	Chapter 6, section 6 Chapter 10, section 4
The company proposes to use direct procurement for customers (DPC) to deliver eligible schemes, in line with our 'DPC by default' approach.	Chapter 3, section 8 Appendix 5 – Direct Procurement for Customers
The company provides sufficient and convincing evidence that the investment proposals within its PR24 business plan are deliverable. This should take into account delivery in the 2020-2025 period and any measures the company has put in place.	Chapter 6, section 6 Appendix 9, section 5.4.4

Outcomes

Here we consider whether plans meet our minimum expectations for outcome delivery incentives (ODIs) and bespoke performance commitments (PCs).

Table 11.6 Minimum expectations for outcomes

Minimum expectations	References
For ODI rates for common PCs the company uses: • the marginal benefits identified through the collaborative customer research, or provides compelling evidence for any alternatives; and • our view of indicative benefit sharing factors, or alternatives supported by sufficient and convincing evidence consistent with the considerations we have set out in our final methodology.	Chapter 5, section 5
If the company's business plan includes bespoke performance commitments, the company sufficiently demonstrates how it has responded to any feedback we have provided on its bespoke performance commitment submission. The company should also provide complete, consistent and well-evidenced incentive rates for bespoke performance commitments, demonstrating how its proposals are consistent with our final methodology and any relevant guidance.	Chapter 5, section 3

Risk and return

Here we consider whether business plans meet our minimum expectations for risk and return.

Table 11.7 Minimum expectations for risk and return

Minimum expectations	References
The business plan uses our early view of the allowed return on capital or provides compelling evidence that another rate is more appropriate.	Chapter 7, section 4
The company's plan provides sufficient and convincing evidence that the overall business plan provides an appropriate balance of risk and return.	Chapter 7, section 3
If the company's business plan includes bespoke uncertainty mechanisms and notified items then these meet the expectations we have set out in our methodology.	Chapter 7, section 3
The company's Board provides assurance that its business plan is financeable on the basis of the notional structure and this is supported by sufficient and convincing evidence that demonstrates financeability and the steps taken to provide this assurance.	Chapter 8, sections 3 and 6
The business plan provides sufficient and convincing evidence to support PAYG and RCV run-off cost recovery rates. RCV run-off rates are within our expectations set out in Chapter 8 and take account of intertemporal fairness and considerations of affordability for customers now and in the future.	Chapter 8, section 4
The company's Board has provided assurance that it will maintain financial resilience during 2025-30 and in the long-term, taking account of its business plan under its financing and capital structure. We also expect this to be supported by sufficient and convincing evidence of the steps taken to provide this assurance and of the steps to improve financial resilience where necessary.	Chapter 9, sections 3 and 4
The business plan sets out the company's dividend policy for 2025-30 and the policy is in line with our expectations.	Chapter 9, section 6

The business plan sets out the company's policy for performance related executive pay during 2025-30 and the policy is in line with our expectations and Board leadership, transparency and governance principles.	Chapter 9, section 7

11.3.2 Ambition assessment

We want companies to produce PR24 business plans that include ambitious proposals that reveal where the sector can stretch to deliver significantly more for customers, communities and the environment during the next price control period.

Companies that pass our quality assessment will receive rewards when their plans also include ambitious proposals that do not require a material level of intervention or improvement on costs and service. Companies will receive the greatest rewards when their plans reveal where and how our determinations should push the frontier for all companies. They will receive penalties if they show a lack of ambition in this part of our assessment and therefore material intervention or improvement is required to produce the company's determinations.

Stretch and efficiency

Given the challenges facing the sector, companies will need to strive to transform their performance and we will continue to place a strong emphasis on stretch and efficiency at PR24. This approach delivered improved outcomes for customers and the environment at PR14 and PR19. Consequently, ambitious plans will include stretching but achievable levels of service at an efficient and affordable cost to customers. The most ambitious plans will reveal sector-leading information which we can use to stretch the entire sector to be more efficient and deliver more for customers, communities and the environment. Our assessment will include considering the extent to which:

- companies propose to deliver stretching performance from base expenditure allowances;
- expenditure proposals are efficient and consistent with our stretching efficiency benchmarks, with any cost adjustments based on compelling evidence;
- enhancement expenditure is well justified, based on adaptive plans, meets customer and environmental needs and makes progress towards delivering relevant government targets; and
- companies propose to deliver best value solutions, by considering wider environmental and social benefits, costs, risks, opportunities for third party funding and the affordability of customers' bills.

Enhancing affordability

Companies' ambition must take account of affordability concerns. Our assessments of stretch and efficiency will support overall affordability by ensuring all customers receive value for money. But we also want companies to explore how they can demonstrate ambition to further enhance affordability overall; for future customers; and residential customers struggling to pay.

If we consider a company's plan overall represents value for money by revealing stretching but achievable levels of service at an efficient and affordable cost to customers, then we will consider financial rewards for the ambition demonstrated by its proposals for enhancing affordability.

To be eligible for these rewards, companies will be expected to demonstrate that they have engaged meaningfully with their customers to understand:

- their priorities for improved outcomes for those customers, communities and the environment for 2025-30 and beyond; and
- their views of how and when statutory requirements are best delivered, ie the outputs specified in WRMPs and the WINEP or NEP.

Companies will be expected to take account of affordability concerns and demonstrate how their customers' preferences are reflected in their overall business plans and long-term delivery strategies, for example in decisions about how they propose to phase investments and service improvements.

Companies should also consider including proposals for high value or innovative ways of supporting customers, such as:

- voluntarily sharing outperformance (see Chapter 9, Section 8);
- making other contributions from investors; or
- delivering charging innovations.[217]

11.4 The rewards and penalties

We will use reputational, financial and procedural rewards and penalties to encourage quality and ambitious plans.

[217] We are consulting on key policy and regulatory considerations, see 'Consultation on charging innovation to support affordability', September 2022. We will expect any proposals to be supported by customer engagement.

11.4.1 Reputational

At PR24, we will assign each company to one of four categories, which are described in Table 11.1 above.

The reputational impact of the categorisations will be significant. During the price review, companies will be labelled by their category and we will refer to these frequently in our PR24 communications and beyond. We will:

- explore how we can communicate the outputs of the QAA to a range of stakeholders and provide a platform for ambitious companies to demonstrate their aspiration for the sector; and
- expect companies to state their category prominently on direct communications with their customers and stakeholders, for instance on bills, in annual reports and on their websites.

Our goal will be to make the outcome of our assessment visible to a broad range of parties.

11.4.2 Financial

Directly applicable financial rewards will encourage companies to prepare ambitious plans containing sector leading proposals.

Directly applicable financial penalties will discourage companies from:

- providing plans of insufficient quality; or
- plans that lack the ambition needed to push forward the sector's performance.

Every company should be capable of providing a quality plan, therefore any company categorised as inadequate will receive the maximum financial penalty. However, when determining a financial penalty for any company categorised as lacking ambition, we will consider the level of ambition and the degree of improvement or intervention required in their proposals.

To illustrate the value of financial rewards and penalties, a company with a regulatory equity of £1000m that receives the maximum + 30 bps adjustment would receive an adjustment equivalent to £3m in each year of the price control. Companies can choose to receive their reward, or incur their penalty, as adjustments to revenue or their RCV during 2025-30. Adjustments to revenue or RCV will have the same net present value.

We will also use pre-determined cost sharing rates for 2025-30 using each company's categorisation, as shown in Table 11.1. Companies achieving higher categorisations will receive more favourable rates than those in lower categories.

11.4.3 Procedural

We expect all companies to provide a quality plan. All companies passing our quality component will benefit throughout the price review because they will need to respond to fewer queries.

Companies that achieve our highest categorisation will receive protection from potential reductions in the allowed return on capital and base cost allowances between draft and final determinations. These companies would still be eligible to benefit from any increases between draft and final determinations. They will be able to reduce their engagement in the price review and focus on delivery for their customers, communities and the environment.

11.5 Quality and ambition in the first business plan submission

We want companies to provide quality and ambitious proposals in their first business plan submission. We reserve the strongest rewards for those companies.

When determining the QAA categorisations and associated rewards or penalties we publish at the time of our draft determinations, we will only consider the evidence provided in the first business plan submission and responses to any clarification queries (other than new evidence). However, to make sure that our draft determinations are robust and in the best interests of customers, communities and the environment we will request evidence we consider is missing from a company's first business plan submission as appropriate.

We have considered feedback from stakeholders but believe companies will have sufficient information to provide a quality and ambitious plan in October 2023 (see Appendix 12 – Quality and ambition assessment.) They should be seeking to provide quality and ambitious proposals on their first submission. However, when improvements are necessary we may – exceptionally – move a company out of the inadequate or lacking ambition categories if they make significant improvements between draft and final determination. Relevant companies will need to strive to meet our expectations of a quality plan in the round or make improvements that mean we do not need to intervene significantly on the level of ambition they propose to deliver ahead of final determinations. Companies that get their business plan submission right the first time will always be better off in terms of QAA rewards and penalties than those who did not.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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