July 2015

Trust in water

Reflections on the price review - learning from PR14

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About this document

This document sets out the key reflections on our 2014 price review programme along with our next steps. These reflections cover the period from the publication of our methodology in July 2013 to the publication of final determinations in December 2014. It does not review the decisions made on price limits.

The document briefly describes the price review process and how we sought to identify the key learnings from the review. It then discusses the key reflections by the different programme areas. We conclude by listing the next steps that we and others should take so that we can help build trust and confidence in water.

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Executive summary

Protecting customers' interests sits at the heart of our primary duties and our approach to economic regulation. However, customers' – and society's – concerns and expectations are dynamic and change over time. More and more, water companies need to be able to respond quickly to that. This is why we have been changing how we regulate – moving to a more targeted and proportionate approach that gives companies ownership and accountability for delivering what customers want.

This new approach meant we changed the way we approached the 2015-20 price review (known as PR14). We introduced a new methodology designed to take the water sector in England and Wales on a journey that we expected would increasingly put customers – and not the regulator – at the heart of the business planning process.

In headline terms and in its impact, the review was well received: companies generally responded well to the new approach and it will deliver an average 5% real term cut in customer bills and £44 billion of new investment over the period. However, as this is a fundamentally new approach to how we operate there were naturally some challenges and we wanted more robust intelligence about how it had worked. This will help us, companies and other stakeholders learn from our experiences and deliver better outcomes for customers in the future.

We have therefore carried out a wide-ranging review, to understand what went well and what could be improved, narrowly in terms of the review process, and more widely in terms of the way we work. We have had open discussions with many of those involved, from across the sector to elicit this information. We also invited Ed Humpherson, Director General for Regulation at the UK Statistics Authority, along with Dr Eileen Marshall CBE; Bob Spears, Chairman of UCC Services; and Chris Watts, Ofgem, to give us an honest external perspective. They provided us with valuable insights that will help shape our future work programmes.

This report contains the key learnings and the steps we will take not just for future price reviews but across the range of our work. In terms of the key principles that underlie our approach, there were important findings.

We wanted companies to focus on what customers wanted and expected from their services.

There was real evidence of companies listening and delivering the outcomes their customers wanted. The customer challenge groups (CCGs) were critical to delivering this result as they pushed companies to deliver more for customers. The outcomes framework was important in initiating the conversation between companies and customers, and aligning the interests of investors with those of customers through the outcome delivery incentives (ODIs).

Looking ahead, we continue to consider that there are opportunities for companies to better understand their customers' priorities, potentially by using information from day-to-day interactions with them. At the same time, we think more powerful delivery incentives could help drive innovation and better outcomes for customers.

We wanted companies to take more ownership for delivering high-quality plans, with greater Board involvement and less need for regulatory intervention.

Some companies embraced the new methodology and delivered high-quality plans that we were largely able to accept in the round under our risk-based review. But there were still many examples where we considered that companies could have done more. This was most apparent in relation to the allocation of costs, and the way companies sought to identify and manage risks, which typically resulted in requests for higher cost allowances.

We recognise that we could have done more to help empower companies and customers during the price review too. For example, if we had been able to share comparative information early in the process, or had given more clarity over how we would make adjustments for 2010-15 performance, then this could have reduced the need for interventions by us in companies' plans.

Looking ahead, we think there are opportunities to further embed the enduring future price limits (FPL) principle of company ownership through better use of financial, procedural and reputational incentives in the risk-based review. At the same time, we consider that companies still need to improve their understanding of costs and the allocation across different services – this is a really critical aspect of taking forward further change effectively.

We wanted to reveal new information about customer priorities, performance levels and the cost of different services.

The experience from PR14 suggests that the introduction of targeted retail and wholesale controls delivered greater visibility of costs and greater management focus on the different services. We also consider that the outcomes framework, underpinned by our transparent approach, revealed a wealth of information about customer priorities and service levels.

The revelation of this information is critical to how we want to regulate – it helps promote better decision making and reduces the need for regulatory intervention. So we expect the information revealed by PR14 to help promote better decisions across a wide spectrum of activities, such as:

- how services are delivered;
- buy/sell decisions; and
- decisions on how risks should be managed.

This will inevitably deliver benefits to customers, the environment and society.

Looking ahead, we think there are opportunities to reveal more and higher-quality information. This is particularly relevant in relation to the cost of providing services and customer priorities. We will also continue to look for opportunities to apply targeted price controls – consistent with our enduring FPL principles – as our experience in PR14 suggests that it will help reveal more information and focus management attention on different areas of the value chain.

We wanted the price review to deliver challenging but fair targets, maintaining the sector's ability to attract long-term investment.

The approach to setting the wholesale and retail cost allowances was characterised by setting challenging targets through comparative modelling, then allowing specific adjustments where companies provided strong justification and evidence. This provided a sound basis for setting revenues in light of the information asymmetry between us and the regulated companies.

Alongside the determination of cost allowances, we put a greater focus on operational outperformance through lower allowed average returns. We think this helped strike a sensible balance between protecting customers, while ensuring companies are funded and incentivised to deliver high-quality services.

Looking ahead, we will consider whether our models are sufficiently challenging and whether there are opportunities to strengthen the incentive for efficiency. This includes exploring whether more could and should be done to support water trading, and whether we can increase the power of incentives for operational outperformance. Companies may also wish to reflect on their experience to identify opportunities to improve their business plans next time.

We wanted to empower companies to focus on the resilience of services and resilience more widely, including the resilience of ecosystems.

The outcomes framework empowered companies to understand long-term asset health and develop measures to give visibility to how they meet their legal obligation to maintain and improve the health of assets. We also introduced changes that will help better ecosystem resilience[1] and financial resilience[2].

The results from the price review were mixed: in relation to asset health, some companies thought hard about what this meant to customers and developed measures that gave visibility to how they will look after assets. But we had to make a range of interventions to some plans to improve the visibility of how companies will look after their assets and to increase the power of the incentives.

In relation to other forms of resilience, there were a number of positive developments. In the final determinations, companies committed to developing more than 100 catchment management schemes and improving the water quality at 50 beaches. Similarly, most companies embraced the flexibility given to them to manage their own financeability, with many seeking to use the tools to promote a more financially resilient plan.

Looking ahead, we think there are opportunities for companies to provide greater visibility over how they are planning for the long term. Similarly, we expect that companies will be looking for opportunities under the totex framework to promote eco-resilience within the control period.

We wanted to strive to be an efficient and effective regulator, working at the leading edge, challenging ourselves and others to deliver the best outcome for customers.

[1] This occurs through the use of a total expenditure (totex) approach to cost assessment. This approach seeks to address the sector's bias towards capital solutions, which typically have a much higher impact on the environment than operating cost solutions.
[2] We introduced new levers that gave companies the flexibility to manage their financeability.

The delivery of the this price review was particularly challenging: it delivered 65 determinations in just over a year, compared with the previous review which delivered 22 determinations in 472 days; or, for example, the energy distribution review which delivered determinations for 14 distribution network operators in 515 days. This was also significantly different from than previous price reviews, requiring changes to both method and culture, within a tight timetable. We are very grateful to all the parties involved in this process and we recognise the huge collective effort required to meet the challenges of the process and timetable.

To deliver PR14, we adopted a flexible approach to the process. We hoped that this would allow us and companies to deploy resources where they would deliver the most value for customers, although it also made the timetable even more challenging. Similarly, we engaged widely and more often than at previous reviews. This helped to embed the new approach to the price review, particularly the cultural changes.

Finally, we used a new delivery model in PR14 whereby we worked with a delivery partner to supplement our resources. This delivery model:

- allowed for the rapid mobilisation of resources during peak periods;
- helped promote the development of staff internally; and
- embedded our new programme and project way of working.

Looking ahead, we see a continued need to operate flexibly. We also expect that companies will need to operate flexibly so that that they can respond to changing circumstances. And we will seek to agree early our delivery model by considering in parallel the PR19 policy framework and our own capabilities following the Comprehensive Spending Review. This model will seek to take advantage of opportunities to make delivery less stretching, by reducing the level of engagement and realising efficiencies with submission of information and documentation.

We would like to thank everyone who contributed to this review and report. We spoke to a wide range of people involved in the price review, from Ofwat staff and company Chief Executives to CCGs and government representatives. Everyone was generous in the wealth of information they shared and we are grateful for the time and effort they gave.

1. Introduction

The 2014 price review (PR14) represented one of the biggest changes to how we regulate the water and wastewater sector in England and Wales over the past two decades. Companies were required to engage with their customers to identify and deliver the outcomes that their customers valued most highly. Alongside a greater focus on customer engagement, we introduced a number of changes such as:

- separate retail and wholesale controls;
- a total expenditure (totex) based approach to wholesale cost assessment; and
- default tariffs to support non-household retail competition.

From the perspective of customers and in headline terms, the outcome of the review was resoundingly positive – customers in England and Wales are set to get more from their water companies while paying less in real terms over the next five years.

To ensure that we can build on PR14 and learn from our experiences, we launched a project to reflect on the price review and identify key lessons. This reflection is critically important given that PR14 represented a fundamental change to how we, and the sector, carried out price reviews. By reflecting on the experiences of all those involved we will be able to identify opportunities to improve how we regulate, and similarly opportunities for others to improve how they plan and deliver for customers.

We have sought to deliver this project in a very open and transparent manner. We have engaged with a wide variety of people, including:

- company CEOs;
- Consumer Council for Water;
- representatives of the Department for Environment, Food and Rural Affairs (Defra) and the Welsh Government; and
- members of the CCGs.

And we have sought to elicit information through a wide range of techniques, including:

- workshops;
- surveys; and
- face-to-face meetings[3].

And we have sought external challenge from Ed Humpherson, Director General for Regulation at the UK Statistics Authority, Dr Eileen Marshall C.B.E, Bob Spears, Chairman of UCC Services, and Chris Watts, Ofgem.

This project cuts to the heart of the type of regulator we want to be – one that is trusted and respected, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

In this report, we present the findings of our evaluation of the PR14 programme. We first revisit the PR14 journey to remind ourselves of both the process and outcome from the review. We then explain the approach we have taken to identify the key lessons, including our sources of information. Next, we present the results of our project, structured across the different areas of the PR14 programme. We conclude by summarising the results and considering the next steps.

This report does not seek to review decisions made on price limits.

We also note that we will continue to learn from PR14. Undoubtedly, some of the key changes in company behaviour (relative to previous price reviews) are not immediately visible and instead will be revealed over time as companies respond to the incentive framework during the period. For example, the effectiveness (or not) of the totex approach is something that we expect to be revealed over time. Similarly, given the Competition and Markets Authority (CMA) is determining prices for Bristol Water, we will reflect on its determination to identify further lessons.

Finally, we are grateful to all those parties that contributed to this report. All parties provided us with a wealth of information and we are grateful for the time and effort they have given to share their reflections of the review.

[3] We discuss our approach in more detail in chapter 2.

Responding to this report

We welcome your comments on the reflections we have captured on PR14 by **10 September 2015**. You can email your responses to Water2020@ofwat.gsi.gov.uk or post them to:

Water2020 – Reflections on PR14
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA.

If you wish to discuss any aspect of this document, please contact Alison Fergusson on 0121 644 7514 or by email at alison.fergusson@ofwat.gsi.gov.uk.

We will engage further with stakeholders over the summer and early autumn and we hope your response will be only one part of an iterative conversation that has already started on the future reform of the regulatory model of the water sectors with such initiatives as the 'market place of ideas'. A number of water companies have contributed to this and we would encourage anyone with an interest to contribute further ideas. We will also carry out a number of workshops and other forms of engagement to build on the lessons and feedback to this paper as well as the wider sector conversation. We cannot make progress alone and need the sector and everyone interested in it to work to consider the way ahead.

2. Background and context

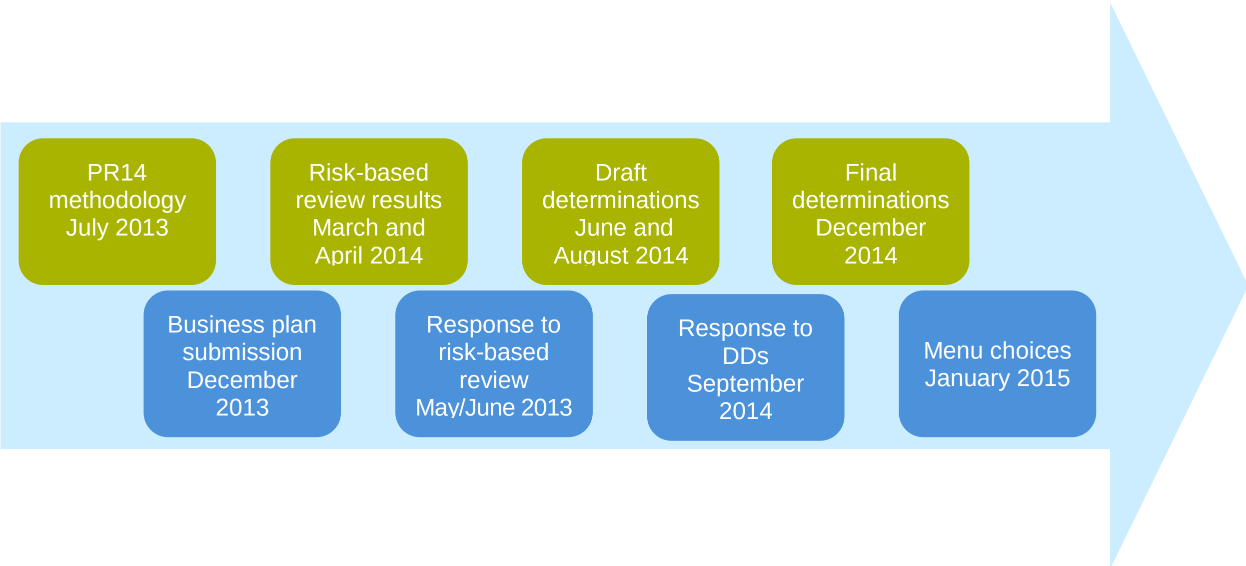
In this chapter, we look back on the key aspects of PR14 with respect to both the process we followed and the outcome of the price review. We then explain our approach to learning from this programme.

2.1 PR14 journey

The PR14 programme started in July 2013 when we published our methodology for the 2015-20 price review and the business planning guidance. Before this, we had engaged extensively on a range of issues to develop the methodology under the future price limits (FPL) programme, the precursor to PR14. This early work included developing the enduring principles by which we would establish our methodology, along with numerous issues papers and consultations to develop specific proposals[4].

Following the publication of the methodology, there were a number of key milestones reflecting the submission of information by companies and other stakeholders and the publication of our decisions. We illustrate these milestones in figure 1 below.

Figure 1 PR14 process



[4] For further information, please see https://www.ofwat.gov.uk/future/monopolies/fpl.

2.2 Outcome of PR14

PR14 delivered a set of final determinations which mean customers in England and Wales will get more from their water company while paying lower bills in real terms over the next five years.

The approach to the price review also changed the conversations that companies had with their customers – and the conversations between companies and us. The rationale for this change was that companies' plans for delivering water and wastewater services should be driven by what their customers, the environment and society want, now and in the future. This is critical to our vision of promoting a sector that focuses on delivering what the customer wants, with the regulator setting the underlying framework instead of being the companies' focus.

In total, companies have promised to deliver £44 billion of investment in:

- maintaining and improving services;
- improving resilience; and
- protecting the environment.

One million more people will receive assistance through schemes to help them pay their bills, leakage will be reduced, and fewer properties will be flooded by wastewater from sewers. Companies plan to deliver these improvements with an average drop in water bills of 5% in real terms over the coming five years.

2.2.1 How we have sought to identify the key learnings from PR14

We launched our learning project in February 2015 to reflect on PR14 and identify, share and embed the key lessons for the Water 2020 programme, which includes the design of the delivery of the next price review (PR19). To deliver this objective, we have sought to learn from our experiences in relation to three categories – policy, process and people – across the different areas of the programme.

To identify the key lessons we used a number of techniques and approached the full range of parties interested in our price review. Our techniques included:

- workshops;
- face-to-face meetings;
- structured telephone calls; and
- an anonymous survey.

We also reviewed press articles where stakeholders reflected on the price review, and considered published research such as that carried out by the Consumer Council for Water (CCWater) on the CCG process in June 2014[5] and a Water UK survey of investors carried out by Indepen in June 2014[6].

Finally, we received external challenge from Ed Humpherson, Director General for Regulation at the UK Statistics Authority; Dr Eileen Marshall CBE; Bob Spears, Chairman of UCC Services; and Chris Watts, Ofgem, who shared a number of valuable insights that will help shape our future work programme.

Our panel members broadly supported the findings set out in this report. Some considered there were either areas where the approach at PR14 could be improved or certain priority areas that we should consider as part of our approach to the development of PR19. We summarise these below.

- During PR14 cost allocation proved to be an iterative process and we moved towards a more prescriptive approach as the price review progressed. The importance of progressing high-quality, accurate and consistent cost allocation in other services across companies was emphasised by panel members. If we choose to take forward further targeted disaggregation of the wholesale controls either to facilitate the introduction of more market mechanisms in those upstream services or to support better outcomes through regulation some panel members considered that this cost discovery work would be particularly critical.

- In order to support challenging cost efficiency benchmarks some panel members emphasised the importance of having comparable information on key lines of costs on an on-going basis. This was seen as being a priority for future comparative efficiency and econometric modelling.

- During PR14 we requested extensive customer engagement to inform our affordability and outcomes assessment. Two elements of customer engagement were discussed by panel members in their feedback: potential alternatives to willingness to pay research and the structure and governance of CCGs.

[5] http://www.ccwater.org.uk/wp-content/uploads/2014/07/Customer-Challenge-Group-process-Review-of-lessons-learned2.pdf
[6] https://dl.dropboxusercontent.com/u/299993612/Publications/Reports/Finance/2014-water-uk-investor-survey-report-final.pdf

- There were mixed views on willingness to pay evidence but a number of the panel raised concerns about this and the potential value of supplementing this evidence by using real data and experience obtained either during the day to day operation of companies or from real customer choices.
- Panel members were very complimentary of the role played by CCGs but recognised that their workload had been large. Some panel members emphasised that, if CCGs continue, we should clarify how they should be funded to ensure that they have sufficient resources to undertake their roles effectively whilst also ensuring they remain independent in the process.

- Members of the panel supported our approach to setting incentives on companies during PR14 but made some comment on them, including:

  - that incentives need to be sufficiently strong to influence behavior to be effective;
  - that more targeted incentive schemes focused on particular services could be better at revealing costs and driving efficiency or improvements in service; and
  - that benefit sharing with customers should be done quickly.

- Some panel members considered that it was very important to be as clear as possible at the beginning of the control period about how incentive mechanisms will be settled at the next price control and supported our 'reconciliation rule-book' approach in helping to achieve this.

- Panel members were supportive of the flexibility given to companies in managing their financeability but some members considered that this should not be totally unconstrained.

Beyond the panel members, in terms of interested parties, we have engaged with:

- Ofwat staff – both PR14 programme staff and non-programme staff;
- the Ofwat Board,
- Ofwat's customer advisory panel;
- delivery partner members;
- water companies;
- CCG Chairs and members;
- Consumer Council for Water;
- Defra;
- Welsh Government;

- Environment Agency;
- Natural Resources Wales;
- National Farmers' Union;
- Natural England;
- Blueprint for Water;
- County Land and Business Association (CLA);
- Unison; and
- investors.

We are grateful to all those parties that contributed to this report and the time and effort they have given to share their reflections of the review.

3. Reflections and key lessons from PR14

In the table below, we summarise the key lessons from PR14. We have listed these by reference to whether they:

- relate to a specific area in the programme – in particular, customer engagement and outcomes, wholesale costs, 2009 price review (PR09) legacy, retail, risk and reward, financeability and affordability, and communications and engagement; or
- relate to the programme in its entirety.

For each area, we have listed 'what went well' and 'what could be improved' – either by ourselves and/or with other stakeholders, including companies. We also give a link to Table 2, our 'next steps' table, to show under which strategic objective headings we address what could be improved. We then discuss each of these observations in more detail in the subsequent sub-sections. We also recognise that there were other changes that we were considering for PR14 but did not introduce for a range of reasons, such as the abstraction incentive mechanism (AIM) and the network management incentive. We have not considered lessons associated with these items within this report. Instead, we will reflect on them in the Water 2020 programme.

Table 1 Summary of key lessons from PR14

	What went well	What could be improved	Next steps objective
Customer engagement and outcomes	Greater focus on customers by companies. Challenges provided by CCGs.	Empowering the customer voice (through information). Promoting greater visibility about long-term planning. Addressing the asymmetry of rewards and penalties and ensuring sufficient value is at risk.	Customer – focused sector. Promoting a resilient sector. Company ownership and accountability for delivering what customers want.
Wholesale costs	The use of totex cost assessment. The combination of challenging models and flexibility through special cost claims.	Having data sets earlier so we can spend more time refining the cost models. The analysis and evidence companies used to justify changes to cost allowances.	Driving value for money.
PR09 legacy		Having clear unambiguous guidance in one document for all adjustments.	Company ownership and accountability for delivering what customers want.
Retail	Incentivising efficiencies in the household control.	Simplifying the household retail methodology. Allocation of costs and margins across default tariffs.	Driving value for money.

	What went well	What could be improved	Next steps objective
Risk and reward	Application of a balanced package (including outcome delivery incentives).	Increasing the focus on operational outperformance.	Promoting a resilient sector.
Financeability and affordability	Emphasis of Board ownership of financeability. Introduction of new tools to empower companies (for example, 'pay as you go' – PAYG).		Promoting a resilient sector.
Communication and engagement	Transparency of decision making. Portfolio approach to communications with companies and other parties, including investors.	Efficiency of the documentation. Submission process for business plans and data.	Being an efficient and effective regulator.
Programme	Risk-based review. Targeted price controls. Board ownership. Flexibility of the programme. Delivery partner arrangement.	How the sector and we manage changes to the programme plan. Allowing for more time in the price review timetable.	Being an efficient and effective regulator.

In the following sections, we set out the key lessons across the different areas. We do this by first summarising the lesson (the sentence in blue), before talking through our rationale. We conclude by summarising the next steps (in **bold**).

3.1 Customer engagement and outcomes

At PR14, we asked companies to develop a set of outcomes[7] that reflected what their customers needed, wanted and could afford, as opposed to regulatory defined outputs. These outcomes, and associated performance commitments (PCs) and outcome delivery incentives (ODIs), formed an important element of companies' business plans and final determinations. Below, we summarise the key lessons arising from the customer engagement that companies carried out and the resulting package of outcomes.

3.1.1 Customer engagement

There was a step change in the quality of customer engagement at PR14, with customers being put at the heart of the business planning process. The CCGs played a significant role in helping improve the quality of companies' business plans and provided us with assurance about the quality of the engagement.

PR14 sought to put customers at the heart of the business planning process[8]. It was characterised by high-level, as opposed to detailed, guidance from us, with companies being empowered to take responsibility for the quality of engagement with customers and the way they respond in business plans.

To reinforce our approach, we asked each company to establish a customer challenge group (CCG). The purpose of the CCG was to challenge the company's approach and response to customer engagement. It was not intended to substitute for engagement with customers, or to negotiate a settlement with the company on behalf of customers. The CCGs were also designed to provide us with assurance that the company's business plan:

[7] Outcomes focus on what a company can deliver with its assets and capabilities, not how many assets it has or the activity it carries out.
[8] For further information, see 'Involving customers in price setting – Ofwat's customer engagement policy statement'.

- reflected a sound understanding and reasonable balance of customers' views; and
- considered whether the phasing, scope and scale of work required to deliver the outcomes was sustainable.

On reflection, there is some evidence that there was a step change in customer engagement at PR14. Companies explained that they had reached and engaged with more customers than ever before, with the total number across the sector exceeding 250,000 customers.

Feedback from stakeholders also indicates that the quality of the engagement was higher than at previous reviews and this translated into higher-quality business plans. For example, in its review CCWater noted[9] that for many (CCGs) there was overall positivity about how (customer research) was conducted. Senior people within companies have told us how the focus on outcomes and customer engagement changed the nature of the conversations with their Boards, and helped to engage their staff. But CCWater did identify concerns about what the customer research was actually designed to explore, particularly in relation to 'willingness to pay', which we discuss below.

We also note that most CCGs created extensive 'challenge logs' through the price review process. These logs demonstrated how the challenge from the CCGs resulted in revisions to either a company's approach to customer engagement, such as changing the form of questions, or to changes in business plan proposals. This demonstrates the important role of CCGs in raising the quality of business plans and providing us with assurance about the level and quality of the customer engagement companies carried out.

Another key benefit of the CCGs is that they allowed for better integration of stakeholders such as:

- the environment and water quality regulators;
- green NGOs; and
- customer representative groups.

[9] See http://www.ccwater.org.uk/wp-content/uploads/2014/07/Customer-Challenge-Group-process-Review-of-lessons-learned2.pdf

This integration meant that companies' plans were generally more rounded and captured the different trade-offs associated with their decisions. But we also recognise that some issues were identified about the group composition. In particular:

- there was a substantial burden on small organisations such as the Drinking Water Inspectorate (DWI) to attend all CCG meetings;
- it was considered that business groups were under-represented and difficult to engage; and
- some members of other bodies such as CCWater, the Environment Agency and DWI found it challenging having a dual role.

While feedback across the sector was resoundingly of the view that CCGs were a successful innovation, a number of observations were made about their role (if they are to continue) and the use of willingness to pay information. We discuss these below.

Clarity on role and focus of CCGs

As explained earlier, in developing our framework and methodology for PR14 we did not set prescriptive guidance on how customer engagement should be carried out. Instead, we asked companies to take responsibility for how they engaged with customers and used the CCGs. This was a conscious decision as we sought to drive cultural change with an emphasis on:

- customer-centric business planning; and
- company ownership and accountability for the process and outcome.

In reflecting on this approach, we received feedback from some companies and CCGs that they enjoyed the flexibility. This is because it allowed them to focus their efforts on what mattered most as opposed to trying to second guess what the regulator wanted. It was also thought that the flexibility encouraged genuine company ownership and enabled innovation.

But we also note that some companies and CCGs found the flexibility challenging. This is because the flexibility often (although not always) translated into a very wide remit for CCGs or frequent reworking of papers. For example, it was noted that some CCGs delved deeply into engineering and finance matters. Given that CCGs were almost all volunteers, this flexibility created significant demand on members' time and did not always reflect the capabilities of the different groups.

And we recognise that we changed our expectations about the CCG role through the process. In particular, we encouraged companies to use the CCGs at the end when we were looking again at PCs and ODIs in a way that went beyond the challenge and assurance that we had originally envisaged.

In its assessment, CCWater noted that some members identified the need for clearer and more accessible guidelines, which could help focus efforts and reduce the burden on volunteers.

Leaving to one side the fact that we have not committed to using CCGs for PR19, we consider that there is an important trade-off when considering the use of guidance and that needs to be reflected upon.

On one hand, we recognise that additional guidance could allow for a more focused effort from some CCGs and reduce the burden on members' time. This is particularly relevant in relation to our expectations about the role as it will help planning and the management of CCG members' time. But providing too much guidance could reduce the emphasis on customers and take us back to a world in which the focus is on the regulator. Clearly this is something that neither we nor CCWater would be looking to change. We recognise that there is a spectrum ranging between us providing comprehensive guidance and companies having total freedom and we will need to constantly reflect on where we sit on that spectrum.

We note that without us producing any guidance, most companies have already established a CCG-type group to work with as they deliver their plans over 2015-20. This suggests that the perceived gap in guidance is not holding many companies back from getting on with the job of engaging and delivering for their customers.

In light of these points, we will reflect on how we use guidance as it relates to customer engagement as part of the Water 2020 programme.

Empowering customer voice through information

Another key theme in feedback was a desire to empower the customer voice including CCGs, thereby reducing the need for interventions.

This reflection was most prevalent when CCGs considered the intervention on companies' outcomes at the draft determinations. These interventions related to setting upper quartile performance targets using comparative information for six activities that were similarly defined across the sector – these were referred to as horizontal interventions[10].

Many CCGs welcomed the horizontal interventions. But CCG Chairs noted that it felt as though we were coming in to substitute our views for those of customers, and that they thought they had not been empowered to make this challenge as the information was not available to them.

In reflecting on the feedback from CCGs there is clearly an opportunity to empower the customer voice by sharing comparative information once it becomes available. Such information would allow for stronger challenge to be applied, particularly in relation to service levels. Looking forward, we need to consider whether and to what extent we could provide comparative information on totex, WACC and outcomes so that:

- customers can more effectively engage on subsequent adjustments to plans; and
- CCGs can provide further assurance on this engagement.

Finally, we consider that we should carry out further work to reflect on how we could bolster the independence of CCGs (should they be retained). We recognise that this is particularly difficult in an environment in which the CCGs are dependent on the companies for information and guidance. Therefore, looking forward, if the CCG role is retained we will need to consider how we could strengthen their independence.

Understanding customer priorities – use of willingness to pay

As we have noted, a key objective of PR14 was to place customers at the heart of the business planning process so that companies would deliver the outcomes they wanted and valued most, as opposed to the outputs desired by the regulator. To deliver this objective, companies needed to identify and understand customer priorities. The primary tool used to identify these priorities was willingness to pay information.

[10] 'Draft price control determination notice: technical appendix A2 – outcomes', page 20.

At PR14, willingness to pay information was heavily used in:

- cost-benefit analysis to support enhancement projects; and
- calibrating the rewards and penalties for ODIs.

An issue identified by our own analysis and highlighted by companies was the degree of unexplained variation in willingness to pay information across different companies for apparently similar services and improvements. This difference is best illustrated by the differences in willingness to pay to avoid sewer flooding – which ranged from £25,540 to £434,319 per property.

The variation in the willingness to pay information used for PR14 raises the question – does the information as currently collected reflect what customers want? Given the cultural shift that we are trying to promote across the sector, having an accurate understanding of what customers want is of critical importance.

Instead of relying on willingness to pay surveys once every five years, we are interested in whether companies can also make better use of information that customers reveal in their daily interactions with them. We think complementary in-period information could help companies better understand what customers want and are willing to pay for, which in turn would lead to better decisions about investments and the design of incentives. We are considering this further in our Water 2020 work.

Next steps:

We will continue to promote cultural change across the sector by incentivising companies to focus on delivering what customers want. This means that customers need to be at the heart of everything companies do – and this needs to occur throughout the control period, not just at the planning stage. Promoting this cultural shift will require:

- **our considered use of guidance – recognising the need to give clarity about the role of customer assurance but without shifting the focus of companies back onto the regulator;**
- **empowering the customer voice through the provision of information where possible, particularly comparative information; and**
- **better understanding by companies of customer priorities, which could include looking at how companies could use information generated from interactions with customers within the control period to complement other information they collect.**

3.1.2 Outcomes

Companies embraced the outcomes approach, which has the potential to deliver more for less, benefiting customers, the environment, wider society and investors. However, further benefits may be derived from revisiting the approach to comparative outcomes, the balance between rewards and penalties and whether outcomes should be set for a period of greater than five years.

We introduced an outcomes framework in our PR14 methodology to reinforce the customer-centric cultural change we are promoting across the sector. Under this framework, companies were required to engage with their customers and CCGs and develop outcomes and associated performance levels that customers valued most highly.

Overall, the sector viewed the introduction of outcomes as a positive development. There is almost a universal view from companies, customer representatives, other regulators and NGOs that the outcomes approach has:

- created a much greater emphasis on the need for companies to understand and deliver the priorities of customers rather than those of the regulator; and
- given companies greater flexibility, alongside totex, to identify the most efficient way to deliver services that customers value most.

In reflecting on outcomes, a number of stakeholders have given thought to how the framework can be enhanced at the next price review. These reflections can be categorised under the following three headings.

- ODIs – power of the incentives and the balance between rewards and penalties.
- Whether the outcomes framework is incentivising long-term planning.
- How to best set companies stretching performance targets

We discuss each of these below.

ODIs – rewards and penalties

In our PR14 methodology statement, we explained that introducing ODIs was an important addition to the price review framework. This is because it helps to align the interests of investors and management with the interests of each company's customers by making sure that rewards and penalties are linked to customer preferences.

We have reflected on how ODIs were used in the price review and have identified two issues.

- First, a bias on the part of companies towards reputational incentives instead of financial incentives.

- Second, where financial incentives were adopted, they tended to favour penalties over rewards. Although this reflected what customers wanted, it was a view expressed without an understanding that it would add additional basis points to the WACC (and hence higher bills)

Our concern is that these issues reduce the money at risk and thus reduce the power of the incentives. This also means that companies depended on higher WACCs to provide investors' returns, rather than through returns for operational outperformance. The practical consequence of reducing the power of the ODIs is that is likely to:

- reduce the incentive for companies to improve service levels as such behaviour would generate less value to investors; and
- restrict innovation as there is less money at risk and hence upside from companies taking risks and looking for new and better ways to deliver services.

However, we recognise that engaging with customers on the topic of incentives for operational outperformance is very difficult. This is because it is necessary to explain the concept of remunerating (average) returns on capital employed before extending the discussion to the mechanism for linking returns to operational outperformance. Our concern, which a number of companies also share, is that approaching the issue in isolation does not give customers the full story and can produce misleading results.

We also note the opinion from some stakeholders – in particular, CCWater (and CCG Chairs from CCWater) – are very different to our own. CCWater has argued that customers do not support rewards (and penalties to a lesser degree). This view reflects research from CCWater, which showed that customers did not support rewards on the basis:

- that the service they receive is already very good and they did not need any further improvement, and therefore were unwilling to pay for it;
- of cynicism that water companies would carefully select the targets so that they were unlikely to have to pay a penalty and were more likely to receive a reward.

But we note that some companies also identified alternative views. For example, research carried out by South West Water showed that customers agree that their bills should reflect performance, and that they support mechanisms that encourage the company to improve service and ensure bills are lower in the future.

Similarly, United Utilities said that its customers accept the idea of rewards and penalties, particularly if the focus is more on penalties than rewards. It also thought that customers agree that bills should reflect its performance.

Overall, we agree with the theme from South West Water's and United Utilities' research that companies should face performance-related incentives. We consider that a balanced package of rewards and penalties, with sufficient money at risk has the potential to drive strong service improvements and innovation that will deliver significant benefits to customers.

Given that we are only months into the control period, it is too early to say whether the quantum of rewards and penalties in our final determinations is sufficient to drive material service improvements and innovation. We also will be watching with interest any behavioural differences between those companies that chose to take rewards and penalties annually and those that chose to take the rewards and penalties over the period. We will consider these issues as part of the Water 2020 programme.

Long-term planning

In our PR14 methodology statement, we explained that our overall price setting framework was designed to facilitate delivery of long-term benefits to customers[11]. One way in which we sought to promote this objective was to empower companies to work with customers to develop measures for asset health. This is particularly important because it gives visibility to how companies are fulfilling their obligation under the Water Industry Act 1991 to maintain the health of their assets[12].

Another important tool we used was to require companies to explain how the business plan delivers the best long-term, sustainable solution for consumers, including current and future customers and the environment. This formed part of our assessment in the RBR.

In reflecting on PR14 and long-term planning in particular, a small number of stakeholders have questioned whether the framework did enough to get companies considering the best long-term outcomes. For example:

- some stakeholders questioned whether the (perceived) focus on affordability meant long-term planning might have been suppressed, giving rise to a subsequent peak of investment required in future control periods; and
- others have questioned whether companies might be encouraged to run down their assets under the totex approach, giving rise to problems in the future.

In relation to the perceived focus on affordability, we note that it was primarily the lower WACC that drove falling prices, although the question remains of whether companies anticipated affordability constraints and shied away from carrying out investment in this period in anticipation of these constraints easing in later periods. If companies did this, we do not see anything within our approach, beyond the requirement to listen to customers' priorities that took them in this direction.

On the issue of sweating assets, we reject the notion that there is anything inherent about our framework that could give rise to this problem. As noted earlier, companies have a legal obligation to maintain the health of their assets and this has been given visibility through the asset health ODIs. Accordingly, the failure of any company to maintain its assets would result in:

[11] 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans'.
[12] Sections 37 and 94 of the Water Industry Act 1991.

- penalties under the asset health ODIs; and
- potential enforcement action for breach of the Water Industry Act 1991.

But we do think there are opportunities to promote more structured and visible long-term planning, which could be delivered through the outcomes framework. For example, multi-period outcomes could be used to demonstrate how a company is maintaining its assets to deliver long-term benefits to customers. We note that no company put forward multi-period outcomes at PR14[13], although we recognise that we considered and ultimately rejected mandating multi-period outcomes in our PR14 methodology.

Looking forward, we expect companies to deliver against their PCs, including those on asset health. We will allow them to argue in the next price review for additional expenditure they think is needed to make up for any shortfall in cost allowance from this period. At the same time, we think there is merit in exploring how the regulatory framework, including outcomes, can promote greater visibility about long-term planning and thus reduce the emphasis on the five-yearly price review process.

How best to set stretching performance targets while giving companies flexibility to deliver outcomes for their customers

At PR14, we asked companies to develop outcomes and associated PCs that reflected the needs of their customers. In response, companies proposed more than 500 PCs, many of which differed significantly between them.

In many ways, the differences in outcomes and PCs across the sector vindicates the change in philosophy at PR14. This is because it reveals that customers across England and Wales have different priorities. It is only by putting customers, and not the regulator, at the heart of the conversation can these priorities be revealed and delivered.

But we recognise that assessing bespoke outcomes – in particular, making sure that the performance targets are appropriately stretching – is challenging. Accordingly, we adopted two approaches at the price review to ensure stretching performance.

[13] One company initially proposed a multi-period outcome, but the delivery date was changed so it became a single period outcome.

- For some PCs and ODIs we carried out a bottom-up review to assess whether the proposed service level was stretching and reflected customer priorities.

- For those outcomes that were readily comparable to outcomes that other companies proposed, we carried out a comparative assessment to ensure performance targets were stretching. (These are the horizontal interventions referred to earlier.)

On reflection, and based on the views of CCGs and companies, it is apparent that the comparative assessment seemed to be most effective in allowing the development of stretch targets. But in doing so we had to instruct companies on how they should define and measure performance. This clearly runs counter to a key principle of PR14 and our direction of travel, which is to give companies the flexibility to identify and deliver the outcomes customers value most.

We recognise that part of the challenge in assessing outcomes at PR14 was because they are an innovation. This meant that there was very limited information about historical and comparative performance with which customers and CCGs could challenge companies' proposals. Clearly this will change over time as companies publish their annual performance reports, which detail how they are delivering against the agreed outcomes and PCs[14].

Looking forward, we need to consider options to reduce the need for horizontal interventions. Clearly, one important option will be the provision of information to customers. So we will consider whether and how this information could be made available at an appropriate point in the process to empower customers (and CCGs if they are used) to make that challenge earlier on, reducing the need for our intervention later. This will help ensure that companies focus on delivering the services and performance levels that their customers demand.

Next steps:

The outcomes framework is critical to promoting a sector in which companies take responsibility for delivering their customers' priorities. We consider that there are opportunities to reinforce this behavioural change by:

[14] https://www.ofwat.gov.uk/regulating/compliance/assurance/regreporting.

- **encouraging companies to develop a balanced package of rewards and penalties, with sufficient money at risk – this will incentivise improved performance and innovation for the long-term benefit of customers;**
- **companies doing more to demonstrate how they are planning for the long term, including through multi-period outcomes and delivering for the long term through a focus on continuing asset health; and**
- **Ofwat and companies identifying opportunities to empower customers (through information) so they can provide stronger challenge in relation to performance targets.**

3.2 Wholesale costs

The overall assessment of wholesale costs was challenging but fair – we used a range of benchmarking models (including totex, base and enhancement models), together with an assumption of upper quartile efficiency to develop initial estimates of wholesale costs for each company. We then considered special cost factor claims for each company in combination with our modelling results, to derive our assessment of efficient totex for each company.

In developing our methodology we expressed a desire to introduce a totex approach to assessing costs. Our rationale was that we did not want the regulatory framework to be perceived to favour any particular solution (that is, operating cost solutions or capital cost solutions). In practice, we were only able to develop totex models in relation to the water service, and we supplemented these models with base and enhancement models. Where the wastewater service was concerned, we relied on base and enhancement models.

However, the combination of the modelling and special cost factor claims allowed us to make projections of the efficient level of costs for 28 wholesale businesses. It also allowed us to focus our assessment of detailed more granular issues on the analysis of special cost factor claims.

We note that two out of the three businesses where the differences were biggest – United Utilities wastewater and Thames Water's work on preparing for the Tideway Tunnel – made significant changes to their plans in response to our challenges. In contrast, Bristol Water has challenged our assessment of its wholesale costs as part of the reference to the CMA following our final determinations. Other companies criticised our approach to modelling, but accepted the price controls.

Our view remains that the combination of modelling and assessment of special cost factor claims provided a reasonable basis for assessing wholesale costs. Although the modelling was challenging to companies, they were given the flexibility to come back with specific issues where they considered the cost models did not capture company-specific drivers. This combination arguably works well in light of the information asymmetry that always exists between company and regulator.

But there remains scope to refine and improve our approach to assessing wholesale costs. In particular, we consider that there are opportunities for ourselves and/or companies to:

- refine benchmarking models;
- review the approach to efficiency adjustments – in particular, whether they are appropriately challenging; and
- improve the quality of special cost factor claims – for example, the quality of analysis and evidence from some companies on risk identification and management could be improved substantially.

In reflecting on how these opportunities could be exploited, one constraint that needs to be addressed is the time associated with data collection (which informs the design of the cost models). At PR14, we were constrained by receiving 2012-13 data from companies in August 2013. Looking forward, we need to consider whether we can adopt a more timely approach to data gathering and modelling with a view to publishing models earlier. This would improve transparency and might lead to a more focused approach from companies regarding special cost factor claims.

We have also reflected on how companies responded to our incentives for water trading. At PR14, we introduced two changes to incentivise efficient water trading.

- The first was a totex approach to cost assessment, which was designed to remove any potential bias for capital intensive solutions over operating cost solutions (for example, reservoirs instead of water trades).

- The second was a water trading incentive, which allowed importers and exporters to retain profits over and above that allowed under a traditional price cap.

Companies proposed only one water trade in business plans, although we recognise that there is scope for further trades to be carried out in period. But as we have noted previously[15], along with other groups such as Water Resources in the South East, there appear to be many more opportunities for efficient water trades.

Next steps:

Setting challenging but fair allowances for wholesale costs is important to retain customer trust while maintaining the sector's ability to attract long-term investment. Looking to the future, we think there are opportunities (for ourselves and companies) to improve how wholesale costs are determined. These opportunities include:

- **developing robust data sets early in the control period so that we can refine and improve the modelling of costs;**
- **considering whether the models are sufficiently challenging, including whether efficiency targets should reflect an element of dynamic efficiency as well as historical upper quartile efficiency;**
- **encouraging companies to improve the quality of analysis and evidence that underpins adjustments to cost models; and**
- **examining whether barriers to water trading remain.**

3.3 PR09 legacy

There is an opportunity to provide more clarity over how incentives are accounted for at the end of the control period.

A key activity in a price control determination is making adjustments to forward-looking revenues and/or the regulatory capital value (RCV) to reflect historical performance and the impact of different incentives. These adjustments are typically quite mechanistic as they reflect the application of rules defined at the previous control period (rather than creating new rules).

[15] https://www.ofwat.gov.uk/publications/prs_inf_upsup.pdf.

We note that this activity was particularly challenging during PR14. This was partly because we introduced a number of new incentives and mechanisms at PR09, some of which were very complex. At the same time, there was no single document or model that explained how the adjustments should be applied. Instead, we issued a series of documents and guidance throughout the last control period that sought to provide additional clarity.

Looking to the future, we recognise that there is an opportunity to provide more clarity over how we make adjustments for past performance and the impact of difference incentives. This clarity is particularly important given that PR14 represents a significant change to previous price controls.

At the same time, providing clear unambiguous guidance for how adjustments will be made also reduces the need for interventions. Instead, companies will be able to take ownership for making these adjustments in their business plans.

Providing clear and unambiguous guidance for how incentives and performance will be adjusted at PR19 is something for which all companies have expressed strong support. They welcomed our commitment to publish a reconciliation rulebook in the final determinations and noted that it will support more productive use of resources.

Following consultation, we published the PR14 reconciliation rulebook, which explains how most of the incentives and performance measures will be adjusted for at PR19.

Next steps:

Setting clear frameworks is an important way in which we will empower companies to take ownership and accountability for delivery, while allowing us to apply more targeted interventions. This philosophy is particularly applicable to adjustments for historical performance.

Looking ahead, we will provide clear, unambiguous guidance for the remaining elements of PR14 reconciliation not covered in our published rulebook, which will reduce the need for interventions.

3.4 Retail

We set two different retail controls at PR14 – one for household and one for non-household. In section 3.1 we reflected on the decision to set targeted price controls. Below, we reflect on the methodologies that we applied.

3.4.1 Household retail

Setting allowed revenues by reference to the average cost to serve allowed for a strong efficiency challenge to be applied.

In our PR14 methodology statement, we explained that the most appropriate approach to determining allowed revenues for household retail services would be by reference to the average cost to serve (ACTS) customers across England and Wales. In making this decision, we noted that there was no obvious reason why the cost of providing retail customers in one region should differ from another.

As part of our methodology, we allowed companies to apply for specific adjustments to the ACTS. We allowed such adjustments if they could demonstrate that the cost was material, beyond management control and affected them in a different way to other companies – otherwise the cost would already be reflected in the ACTS.

At a principle level, feedback on our approach to setting the household control was supportive. In particular, most companies and other stakeholders agreed with setting a separate retail control by reference to the cost to serve given the characteristics of retail services.

In reflecting on our methodology, we note the ACTS allowed for a strong efficiency challenge to be applied. This will save customers approximately £300 million over the five years between 2015 and 2020. In hindsight, we question whether we should have set a more challenging benchmark. This is because we observed a significant variation across the sector in the cost to serve as illustrated below. But we also recognise that because this was first time we had set binding separate controls, there was an element of uncertainty in cost allocations.

Box 1: Variation in cost to serve

The retail methodology revealed a wide variation across the sector in the cost of serving customers. This variation is evident in all types of metered and unmetered charges per customer per year. For example:

- the retail component in the unmetered charge for water services, varied from £13.96 to £31.14 per customer;
- the retail component in the metered charge for water services varied from £18.28 to £38.82 per customer; and
- the retail component in the metered dual water and wastewater varied from £29.80 to £42.90 per customer.

We received some feedback that the manner in which we applied the ACTS was too detailed and burdensome. In particular, some companies stated that elements of the process involved us delving into the company's day-to-day management processes as evidence of efficiency, rather than assessing performance and outcomes and then setting incentives.

Another recurring comment that companies made during and after the review was the need for a consistent approach to adjustments. This was particularly prevalent in relation to bad debt adjustments, whereby many companies supported the notion of an industry-wide model. They argued that such an approach would be more consistent with the principle of setting an industry average cost to serve.

Next steps:

Setting challenging but fair allowances for household retail costs is important to retain customer trust while maintaining the sector's ability to attract long-term investment. Looking forward, we think there are opportunities to improve the calculation of the cost allowance by:

- **considering whether our approach at PR14 was sufficiently challenging – for example, should we adopt an 'efficient cost to serve' approach?**
- **working with the sector to identify opportunities to simplify the modelling and reduce the regulatory burden ahead of the next price control.**

3.4.2 Non-household retail

Many companies experienced difficulties in setting default tariffs which necessitated giving them the option of re-opening the control to address cost allocation issues.

In our PR14 methodology statement, we committed to introducing default tariffs to support the introduction of retail competition to all non-household customers in England by April 2017. This will give customers a level of price and service protection while crucially giving the market space to develop. For non-household customers in Wales, we added additional price protection in the form of an efficiency challenge.

In reflecting on our experience, the most striking observation is that companies experienced significant difficulties in developing default tariffs. This was particularly evident in relation to the allocation of costs and the net margin across different charges.

This difficulty is reflected by the fact that we:

- removed the determination of default tariffs from the RBR;
- issued nine additional policy documents to give further guidance (which included the draft determination technical appendices); and
- committed to giving companies the opportunity to re-open the non-household control ahead of April 2017 to address allocation issues.

The key lesson from this experience, which is consistent with earlier messages, is that companies need to improve their approach to understanding cost drivers and allocating costs. This is particularly important as they need to ensure that there is a level playing field given that they own the risk of non-compliance with competition law.

Besides reflections on cost allocation, a number of stakeholders also provided feedback on the size of the non-household margin. We discuss this below.

Size of the non-household margin

A number of parties, including retail entrants, have expressed the opinion that applying a net margin of 2.5% to both retail and wholesale costs is insufficient to promote retail competition. This is because they consider that the margin is insufficient to cover working capital[16], a switching incentive and a profit margin. This feedback often referenced the Scottish market experience and 'gross' margins in that market.

Before discussing the comparison with the Scottish market, it is useful to recall our approach for deciding that a net margin of 2.5% was appropriate. This approach explicitly considered the adverse effect on competition should insufficient margin be allowed for. Therefore, we carried out a two-part analysis, comprising:

- benchmarking with retail margins in other (competitive) sectors, which revealed that the 2.5% figure was above many of the comparators we considered; and
- bottom-up return on capital analysis, which suggested a net margin in the range of 0.55% to 1.10%. Our advisors, PwC, published a separate report on this issue, which is available on our website.

[16] We note that the approach to credit terms is currently under consideration ahead of market opening.

As our risk and reward guidance was for a net margin that is more than double the high end of the bottom-up range, it provided us with a degree of assurance that our guidance was not too low. Also, all companies could have provided justification for a higher net margin if they felt that was appropriate – but this did not occur.

The comparison with the Scottish market is more difficult because the form of the default tariff control is different in Scotland and the gross margins calculated in different ways. This makes direct comparisons more difficult. But we did consider the net margin elements of the Scottish default tariff in reaching the 2.5%.

We also think that any consideration of the net margin should be accompanied by an assessment of the underlying cost of providing retail services. If companies can provide a service at a lower cost than their competitors, they will be able to retain some of the savings, which in effect will increase the profit margin.

This is a particularly important point given that:

- we did not apply an efficiency challenge to non-household costs. Instead, we only challenged companies' proposals where they could not provide sufficient justification for increases in costs of over 5.3% (our materiality threshold) from their 2013-14 base; and
- for household services, we challenged companies' actual costs by around 7% based on an average efficiency. Given that we had regulated the household and non-household services in a similar manner before PR14, this suggests that there are likely to be significant opportunities for an efficient retailer to enter the market and identify savings.

Next steps:

The introduction of choice for all non-household customers in England is an important step towards promoting a customer-orientated sector in which companies are accountable for delivering what customers want. We will support the development of the market by giving companies the opportunity to examine how they are allocating costs and net margins across different non-household charges. Where issues are identified, we will propose new allocations in 2016.

For companies that are wholly or mainly in Wales, we will look at how we can set challenging but fair allowances for non-household retail costs.

3.5 Risk and reward

We used a number of tools to place greater focus on operational outperformance.

A key objective of PR14 was to provide effective incentives that would:

- drive companies to deliver the best service to customers; and
- ensure that risks are allocated to those parties best placed to manage them.

The extent to which the risk and reward framework will deliver our objective will not be clear until later in the period when companies report on progress delivering against their business plans. But initial feedback from companies suggests that the risk and reward package of lower allowed average returns has meant there is greater focus on identifying opportunities for operational outperformance. This outperformance is with respect to both:

- totex outperformance, which involves delivering a service at a lower cost; and
- service outperformance, which involves providing a service at a higher level (for example, reduced leakage).

We also consider that the focus on operational performance will be amplified by the position we adopted on the company-specific uplift to the WACC. While feedback about introducing a benefits test from the water only companies was largely negative, we did receive positive feedback from CCWater and some CCGs which argued that customers should not pay for inefficient structures.

Another point that we need to reflect upon is the request from some companies for earlier guidance about the cost of capital. Although we shared our expectations that the cost of capital started with a three before business plans were submitted[17], companies noted that this was too late in the process to allow changes to those plans. Clearly, we will need to reflect on the timing of our signals. But as we said earlier, we also expect companies to operate more flexibly.

Finally, we recognise that there is a question about whether we can do more to increase companies' focus on operational outperformance instead of financial outperformance. For example, have we got the balance right between allowed average returns and returns from totex and ODI outperformance? This is something we will need to consider going forward.

[17] http://www.ofwat.gov.uk/mediacentre/speeches/prs_spe20131113water2013sbrown.pdf.

Next steps:

Applying effective incentives is an important tool to encourage companies to identify efficiencies and therefore create value for customers. To continue the journey from PR14, we will look at how we can encourage companies to continue their focus on operational outperformance

3.6 Financeability and affordability

The flexibility afforded by PAYG and RCV run-off rates allowed Boards to take greater ownership of the financeability of their businesses.

Consistent with our principle of giving companies greater ownership and accountability for delivering what customers want and need, at PR14 we empowered them to be responsible for demonstrating the financeability of their business. A key feature of our approach was to give companies new levers to manage financeability. This meant they could bring cash forward from future periods into the current control period if required, while making sure customers were no worse off over the long term.

These levers are important because they complement our outcomes framework and use of totex cost assessment. This is because outcomes and totex will naturally give rise to a different mix of expenditure (that is, opex and capex) than what has historically occurred. Without the ability to flex the levers this could raise financeability and affordability issues.

In their feedback, most companies supported our approach to financeability. The resounding view was that the flexibility afforded by the new levers was very helpful in managing financeability and affordability. This is consistent with our view of the tools.

We also received feedback from a small number of stakeholders that we should have issued more guidance – particularly in relation to target ratios. However, we do not accept this point as the publication of our view on target ratios would have undermined Board ownership and responsibility for financeability of business plans. We note further assurance was required for several companies before the draft and final determinations. This is clear evidence of giving companies flexibility but also requiring assurance that they are using this in the best interests of customers.

We also note that some companies struggled with the stronger emphasis on notional financeability than at previous price reviews. But we see focus on notional financeability as a real strength of our approach, as it ensures that companies – not customers – pay for decisions around financial structure.

Next steps:

It is critical that companies have the tools to own and manage their financeability and affordability. This is because it reinforces our principle of company ownership, and because it complements the outcomes and totex approaches. We will continue our approach to financeability from PR14 with a particular emphasis on company ownership.

3.7 Communication and engagement

3.7.1 Transparency, documentation and information

We published more information about this price review and our decisions than at any other price review. However, the volume of documentation meant it was difficult for some parties to identify the information they required.

One of our enduring FPL principles was to regulate in a way that is transparent and predictable. This is fundamental to the type of regulator we want to be because transparency supports better decision making from all parties, which in turn reduces the need to intervene.

At PR14, we gave effect to the enduring FPL principle through our information notice on transparency information sharing (IN 13/22), which explained our commitment to be transparent in how we would make our decisions throughout the price review. We also asked companies and other stakeholders to embrace this principle.

The outcome of this policy was that we published the vast majority of documentation generated through PR14, including internal Board papers. We also recognise that a number of companies embraced this principle and published key documents, including regulatory submissions. But we also observed that a small number of companies consistently tried to restrict information being shared in the public domain.

Overall feedback from stakeholders on our approach to transparency was very positive. In particular, they noted that the level and clarity of information we provided meant it was much easier to understand our decisions and thus respond in a targeted manner. They also highlighted our published Board papers, which were seen as being helpful to many of our interested parties as they provided succinct summaries of key issues.

We received some feedback that the volume of published information was excessive. According to some stakeholders this meant it took some time to find information at the right level of detail. We note that there is no inherent trade-off between transparency and accessibility of information; but there is a need to consider how to communicate results to allow stakeholders to access relevant information in the most convenient manner.

One area of feedback that highlighted opportunities for efficiencies was in relation to the draft and final determinations. In particular, it was noted that there was significant amounts of repeated text which added to the documents' length. At the same time, parties acknowledged that the quality of the documents was very high.

Finally, one activity that we have reflected on is how information is shared between ourselves and companies. We note that the submission, validation and loading of business plan data was particularly resource intensive. Given the short time frame to assess and make the final determinations, we do not think this was the best use of our resources. Looking forward, we think there are likely to be some opportunities for reducing the cost of this process through better use of technology – for example, having companies upload the data directly to our information systems.

Next steps:

One of the most important features of a price review is that it generates a wealth of information. We think it is critical that this information is made publicly available so that all parties involved in the sector can make better decisions. Looking forward, we think there are opportunities for ourselves and the companies to improve the information that is revealed by:

- **committing to adopt a policy of transparency (in relation to decisions that affect customers);**
- **identifying opportunities for efficiencies around documentation (business plans and determinations);**
- **tailoring information to cater to the different interests of stakeholders; and**
- **utilising technology to reduce the cost of sharing information.**

3.7.2 Communication and engagement between Ofwat and interested parties (including companies)

There was generally strong and effective communication between us and different parties which was supported by a lead contact. However there were missed opportunities for stronger engagement with some parties and we could have spread more engagement across the senior leadership team.

As we have explained earlier, our PR14 methodology was designed to drive cultural change across the sector with a much stronger focus on customers and company ownership. While the new incentives and frameworks (such as outcomes) will be a critical driver of this change, they would not work without effective communications.

At PR14, we placed a huge value on conversations to embed the cultural changes. These conversations were particularly important given the step change from the PR09 methodology, which meant we needed to keep communication open throughout the price review to secure the best outcomes for customers.

The feedback from companies was that that the level and quality of engagement with us was very good. On the whole, companies were able to have conversations with us when they wanted to. Portfolio Leads – a named single point of contact within Ofwat – was a concept that companies wholeheartedly appreciated.

We have also noted feedback from companies and our own Board that they really appreciated the opportunity to meet following the submission of business plans. These meetings helped improve our understanding of those plans, and allowed companies to draw out areas of most importance to them.

While the experience for most companies was positive, there were some instances where things did not always work. This was attributed to some messages not being escalated internally by us and our Portfolio Lead role changing at different times. Some companies also expressed the view that they would have liked the opportunity to have spoken to other members of our Senior Leadership Team during the price review. This is something that we are supportive of, given that it would help share the burden of the price review across the wider team.

We also note that some parties raised questions about the burden of engagement and its impact on the decision-making process. These questions, and our view, are set out below.

- Could engagement be done more efficiently instead of matching each interested party with a lead?

- Does proportionate and targeted engagement, which results in some companies speaking to us more than others lead to an inequality in our understanding of company plans or inconsistent judgement?

- Should engagement be closed down earlier in the process to allow decision making (that is, against a stable baseline)?

In relation to the scale of engagement, it seems possible that we could reduce our efforts at the next price review. Given that the changes in PR19 are unlikely to entail such a cultural shift, there seems to be less compelling reasons why we would need such extensive and constant communications. We are also mindful of the potential impact of the Comprehensive Spending Review, which will impact our delivery model for the next price review.

On the second point – we do not consider that targeted and proportionate engagement has negative consequences for customers. In fact, we think this type of engagement is positive because it promotes more effective use of resources across the sector, thereby generating better outcomes for customers.

Finally, we recognise that there was a large volume of engagement towards the end of the price review. There is clearly a benefit to this engagement because it ensured that we had access to the best information to make our final determinations. But it also meant that the baseline against which we made our determinations was moving. This compressed the time for analysis and decision making. Given that the next price review is unlikely to entail the same cultural changes, we think there is an opportunity to close down engagement earlier in the process.

In relation to engagement with other stakeholders, the feedback was generally positive, reflecting again the role of the Portfolio Lead. However, we did receive some feedback that we could have cast the net wider to include groups like retail entrants, along with more focused engagement on some groups. We also recognise that there were opportunities for more discussion and information sharing with Defra. This is particularly important given its leading role in initiating the retail market.

Finally, we received very positive feedback from investors on the quality and frequency of our communication with them. In particular, there was appreciation for our efforts to keep the investment community informed about our price review methodology and expectations around the WACC.

Next steps:

Conversations are a powerful tool in the regulatory tool kit because they help drive change without heavy-handed interventions. At the same time, we place a lot of value on these conversations because it allows us to reflect on the views of different groups and improve how we regulate the sector.

Looking ahead, we think there are opportunities to learn from PR14 and consider how we engage to improve our regulatory efficiency and effectiveness. This could include:

- **spreading more engagement across our Senior Leadership Team;**
- **maintaining a Portfolio Lead contact, but reducing the volume of engagement where the price review methodology entails less cultural change; and**
- **closing down engagement earlier in the price review process to allow more time for analysis and decision making.**

3.8 Programme

In this section we describe two different groups of observations. Firstly we discuss those made on the overall approach of the price review programme, such as including the risk based review, using targeted price controls, and making company Board ownership of plans explicit. Secondly we include observations on the process of running the programme which include the flexible approach, our timetable and the model of delivery using a Delivery Partner arrangement.

3.8.1 Risk based review

The risk-based review (RBR) helped promote a more proportionate and effective approach to price setting.

In the PR09 lessons learned and the enduring FPL principles, we explained that previous price controls had become less effective, characterised by diminishing efficiencies, and yet increasingly burdensome. The RBR helped to address this problem by:

- incentivising companies to develop high-quality plans; and
- allowing more targeted interventions on high-risk areas.

This point is reflected by the fact that we 'fast tracked' the South West Water and Affinity Water business plans by accepting them in the round. At the same time, we directed the remaining companies to address the specific areas we identified in our RBR scorecards.

Some CCGs questioned whether customers of enhanced companies benefited from the process. We think there are clear benefits for these customers. The enhanced companies took a risk and submitted challenging plans – this will benefit customers through higher-quality services at lower prices. While the enhanced companies received a financial benefit, this only lasts for five years. In contrast, the efficiencies they will deliver in relation to price and service quality will be enduring – thereby delivering long-term benefits to customers.

Other regulators, in particular the Environment Agency, noted that abolishing draft business plans and using an RBR helped reduce the pressure on their resources.

It was also apparent from the December business plans and feedback from companies, that the RBR helped incentivise companies to produce challenging plans in their customers' interest to enable them to qualify for enhanced categorisation. This helped to drive improvements in the quality of some company business plans.

But we also note that many companies expressed the view that the prize for enhancement was too low to reward those that took the risk of submitting challenging plans (including strong efficiency targets). By way of background, the prize to South West Water for being enhanced reflected both reputational benefits, along with:

- additional 0.5% of allowed revenues across the four controls;
- the application of the 'do no harm rule', which meant the company did not face a lower cost of capital at its final determination (equivalent to an additional benefit of £14 million or 0.6% of allowed revenues); and
- the procedural benefit of having certainty about the key components nine months early, and therefore having more time to identify opportunities for outperformance.

It was noted that to create stronger incentives for truth telling, and the submission of high-quality plans, the prize for enhancement needs to be much larger. This would reward those companies that successfully take the risk of submitting more challenging plan than their peers and reduce the need for interventions.

We also note that some companies and stakeholders expressed surprise that the RBR methodology, and hence criteria for enhanced status, only considered the quality of business plans and not current performance. Looking forward, we think there are opportunities to further incentivise high performance within-period by linking enhanced status at PR19 to performance during 2015-20.

While the RBR was a success, in hindsight it may have been beneficial to have formalised the differences between non-enhanced companies[18]. For example, after the RBR we made a number of changes to the timetable, one of which enabled non-enhanced companies with high-quality plans the opportunity to get their draft determinations earlier. This applied to Northumbrian and Dŵr Cymru.

However, given significant difference in the quality of some non-enhanced plans, retaining two further formal categorisations may have helped signal to companies with lower-quality plans – in particular the Boards – the significant work that was required. Such a signal could have provided the impetus for more immediate and significant action to address the shortcomings, rather than allowing them to persist as they did for some companies.

Next steps:

We want to create strong incentives for companies to submit high-quality plans, thereby reducing the need for interventions and delivering better outcomes for customers. To achieve this, we will consider the design of the RBR for the next price review, including whether we can make better use of reputational and procedural benefits, along with the size of the financial reward.

We also want to ensure that enhanced status reflects both high quality business plans, and high performance during the control period. We will ensure that any 'enhanced' status in PR19 reflects not only the quality of the company business plan but also their performance during the control period, including whether they delivered on their promises to customers.

[18] At the time, we considered that making that differentiation was challenging and therefore we abolished the resubmission category. (See ‘Setting price controls for 2015-20 – pre-qualification decisions’.)

3.8.2 Targeted price controls

The separation of the retail and wholesale controls allowed us to apply different regulatory approaches to better reflect the characteristics of the underlying services and to focus attention on the retail business.

A key driver of the PR14 methodology was the objective to apply more targeted price controls (see the enduring FPL principles). We place a lot of importance on generating high-quality information through targeted controls as it helps to:

- reveal the cost of providing different services, thereby helping parties make better decisions; and
- promote greater management focus on the different elements of the value chain, thereby leading to better management of risks and consistent with the above, realisation of efficiencies.

At PR14, we sought to achieve this objective by introducing for the first time separate and binding controls for:

- wholesale water;
- wholesale wastewater;
- retail household; and
- retail non-household.

Internal and external feedback indicates that the targeted controls were effective and we were able to successfully apply different methodologies to:

- wholesale controls, where we adopted a totex approach, thereby addressing concerns about a capital expenditure (capex) bias (see section 3.3)
- retail household controls, where we determined the allowed revenues by reference to the average cost of serving a customer; and
- non-household retail controls, where we determined revenues that inform the default tariffs, which are being introduced to support the introduction of competition to all non-households by April 2017.

We also consider that having separate retail controls has forced companies to pay more attention to how they manage this part of the business. By incentivising greater focus on retail through the targeted controls significant cost efficiencies have been revealed (see Box 1 below). It has also generated promises from companies to deliver better service levels.

Box 2: Retail efficiencies

In our final determinations, we allowed all 18 companies £4.0 billion of expenditure for household retail services over 2015-20. This represents a 7% reduction from that proposed in the companies' business plans in December 2013. This will save customers £300 million between 2015 and 2020.

We also recognise that applying targeted controls revealed significant issues with how companies were allocating costs. We discuss this below.

Cost allocation

High-quality cost allocation is a fundamental requirement for the type of sector that we want to promote. Companies need to understand their costs and cost drivers, and allocate costs appropriately. Not doing so means that charges are unlikely to be cost-reflective and so may send the wrong signals both within companies and externally. It is also possible that in the future poor cost allocation could also increase the risk that a company faces financeability issues.

At the start of the review we did not set very prescriptive guidance on how companies should allocate costs across the four controls. But, following the submission of business plans, it was apparent that there were inconsistencies between how companies were allocating costs across wholesale and retail; and between household and non-household retail. Some companies had very sophisticated and high-quality approaches to cost allocation while others had more crude methods.

Given the importance of cost allocation to the methodology, we had to issue increasingly prescriptive guidance for the allocation of costs throughout the price review. Although this allowed us to compare companies on an even basis, we recognise it carried a cost of:

- imposing on companies a view of cost allocation that may not adequately take into account the differences between businesses and their cost drivers, and approaches to accounting; and
- giving rise to the risk that cost allocation is set by reference to the lowest common denominator.

Looking forward, we expect all companies, but particularly those with issues that we flagged, to improve their understanding of costs and cost drivers for the different services across the value chain. To the extent that cost allocation does not improve, then as an alternative to prescription, we may be able to work with companies to highlight best practice and good examples. But if that fails to deliver improved cost allocation, then we would need to intervene to ensure better standardisation and therefore comparability.

Next steps:

Targeted price controls are an important tool to reveal information and focus management attention. Consistent with our enduring FPL principles, we will explore opportunities for more targeted controls where the benefits outweigh the costs.

Companies should also reflect on the feedback from our cost allocation tests from PR14 and improve the allocation of costs across different business units. We will consider what, if anything, we should do to help improve the quality of cost allocation in the next review.

3.8.3 Board ownership

Water companies' Boards took much greater ownership of the business planning processes than at previous reviews.

A key feature of the PR14 methodology was a requirement for greater Board ownership. We explained that we wanted each company's board to own and be accountable for the business plan, as well as providing assurance to us that the plan was high quality. This built on our wider initiatives to improve transparency of reporting and ensure significant independent representation on boards and committees[19].

[19] For further information see IN 14/06, 'Expectations for company reporting 2013-14 – Board leadership, transparency and governance'.

Throughout the assessment of the business plans we saw different degrees of Board ownership. For some companies, there was clear evidence of Board ownership with several CEOs noting the unprecedented level of Board direction and challenge, along with participation in various aspects of the process such as CCG meetings. The degree of Board leadership was also illustrated at Ofwat–company meetings. Where companies brought non-executives to those meetings, it became clear which companies were able to give a compelling account of their Board's involvement in the development of business plans and which were not.

While it is hard for us to analyse the outcome of greater Board ownership, we observed that companies with the most evidence of Board ownership also generally required relatively few interventions.

For some companies, we observed less evidence of Board leadership and challenge. This lack of input corresponded with significant interventions for some companies and surprise from those Boards about some issues we had identified repeatedly and communicated back to staff within the companies.

Overall, we think the greater level of Board ownership was a real positive from the price review. This is because for a number of companies Board ownership appeared to help deliver better plans and hence better outcomes for customers. We also consider that Board ownership of plans will deliver benefits through the control period, as the commitment to delivery and accountability exists at the highest level within companies.

Next steps:

Board ownership has an important role in promoting better outcomes for customers and reducing the need for interventions. Therefore, we will consider, alongside our company monitoring framework and strategic assessment framework, how to best incentivise and give visibility to Board ownership of:

- **the planning phase of business plans; and**
- **the delivery within the control period.**

3.8.4 Flexibility of the programme

The flexible and agile manner in which the programme was delivered allowed for better outcomes for customers and the best use of resources.

A noticeable feature of the PR14 programme was that it was conducted in a highly flexible manner. The key driver of this flexibility was that we gave companies ownership of plans, including the form and content. This meant that we had to be more flexible and agile about how we responded to the content of these plans.

This flexibility is illustrated in the following changes to the timetable that arose from the form and content of plans.

- Publishing the risk and reward guidance in January 2014.
- Not using the resubmission category in the RBR.
- Introducing the comparative assessment of outcomes.
- Providing additional guidance on cost allocation to support the development of the retail price controls.
- Introducing two streams for draft determinations (in June and August 2014).
- Publishing the results of wholesale cost assessment ahead of the formal August draft determinations for those companies with the biggest differences in costs.

Overall, the feedback on the flexibility of the programme has been positive. Our Board and the companies recognised that it allowed resources to be deployed on the issues of the most importance, thus delivering better outcomes for customers. For example, the flexible approach:

- allowed us to retain a meaningful RBR by issuing the risk and reward guidance; and
- gave companies with significant cost differences additional time to recalibrate their business plans, leading to some companies putting forward higher-quality proposals.

But it was also noted – particularly by staff across the sector – that this flexibility came at a cost. By changing the timetable, the traditional troughs in the price review process were shortened or removed, creating a consistent peak of work for more than 12 months. This placed a significant burden on people across the sector that worked on the price review. Overall, this higher burden increased the delivery risks to the programme, particularly as less time could be dedicated to activities such as looking at linkages across the different areas.

We also note that there were examples in the price review when parties were not able to respond flexibly to changing circumstances. For example, in late October 2013 we signalled that we expected the weighted average cost of capital (WACC) to start with a three[20]. In explaining why no company submitted a plan that started with a three, the feedback was that the signal was made too late in the process to allow any changes to business plans. Given that there was still one month until the submission date, we question whether companies should have been able to respond more flexibly to this signal. But we will also need to consider the timing of our signals.

Looking forward, we think there is a role for having some flexibility in the timetable as we want to maintain our ability to respond in a proportionate way to changing circumstances. This is critical to being an efficient and effective regulator. At the same time, we also expect companies to operate flexibly and respond to changes.

But we also recognise that this flexibility needs to work in conjunction with a timetable that allows sufficient visibility of the process to enable planning, and for our procedural incentives to be effective. And this flexibility needs to be implemented in a way that does not create disproportionate burdens for staff and thus risk to the delivery of the programme.

Next steps:

The ability to respond to changing circumstances is a key feature of an efficient and effective regulator. Therefore, we will consider how we can design the future timetable to support proportionate changes, and to build in agile programme working.

At the same time, we also expect companies to be more adaptable to changing circumstances rather than sticking to rigid timetables.

[20] http://www.ofwat.gov.uk/mediacentre/speeches/prs_spe20131113water2013sbrown.pdf

3.8.5 Delivery of the price review – timetable[21]

The delivery of the price review was particularly stretching, which reduced time to focus on linkages across the different areas and placed a significant burden on all parties involved in the process.

Delivering PR14 was arguably the most challenging review that the sector has experienced. Leaving to one side the level of engagement (see section 3.8), it was challenging because of the:

- number of new elements;
- increased complexity of the methodology (albeit with substantial benefits); and
- relatively tight timetable.

We delivered 65 determinations in just over a year, whereas PR09 delivered 22 determinations in 472 days and the energy distribution review delivered determinations for 14 distribution network operators in 515 days.

The stretching nature of the price review meant that most of the effort in the Ofwat teams was focused on activities within each specific area and less time was dedicated to making sure all the linkages across areas were joined up. This created a risk that we could have missed opportunities and/or given rise to unintended consequences, some of which could be borne by customers, others by companies and their investors. This was part of the reason that the portfolio team was created – to help mitigate these risks and create linkages across the different areas.

Some companies noted that there was a lack of time built in to the programme to allow adequate understanding of the fundamental changes we were introducing to the way we set prices.

Looking forward to PR19, we recognise that there is a need to create more space in the plan to reduce the risk to delivery and quality. This will help maintain high-quality outcomes for customers and avoid the risk of unintended consequences. This could be achieved by:

[21] We discuss the engagement through the price control in section 3.8.

- giving companies and ourselves more time to develop and assess plans; and
- retaining company ownership of business plans, but providing focused guidance where this would significantly simplify subsequent analysis (for example, by publishing our financial model early, providing better information on cost allocation, and so on) and identifying efficiencies in the process, such as documentation (see section 3.8).

Next steps:

The delivery of a price review is an intensive process for all parties involved across the sector. To make better use of resources both internally and across the sector, we need to identify ways to make the process more efficient and less stretching. This is something that we will consider in the Water 2020 programme.

3.8.6 Delivery partner

The use of a delivery partner allowed us to effectively supplement our resources with specialist skills to meet the peak workload, and provided longer term benefits by developing internal staff and embedding our programme and project way of working

A noticeable feature of PR14 was the use of a delivery partner[22] to support us in making our final determinations. The delivery partner was responsible for providing support to implement the PR14 methodology and thereby deliver the RBR, draft determinations and final determinations. The delivery partner contract itself was characterised by sharing ownership and risk between ourselves and the delivery partner for the delivery of PR14.

Internally, the resounding view is that the delivery partner arrangement was a success. In particular, it allowed:

- shared commitment between the delivery partner and ourselves to deliver a successful outcome from the price review;
- rapid mobilisation of resources at the start of the delivery phase and avoidance of delays and overhead associated with multiple bespoke procurement of resources during the process;
- delivery partner involvement and contribution to the leadership of the programme and the ability to look across the delivery of the price review by a combined team;

[22] The delivery partner comprised PwC, CEPA and Jacobs.

- access to flexible and responsible resources during peak periods such as the RBR and August draft determinations;
- access to cheaper rates through the discounted framework; and
- promotion of strong team identity, which may not have occurred through the normal use of consultancy support.

The delivery partner also played a very important role in the development of our staff. A key enabler was that the programme operated as a single team across both our Birmingham and London offices. This meant our staff were able to work alongside delivery partner colleagues and learn from their experiences. This lesson is particularly important in the context of our transformation programme, and embedding programme and project working.

Looking forward, we consider that the delivery model for the next price review will be a function of:

- what policy framework we need to deliver – which will inform the skills, experience and quantum of resources required; and
- what resources are available internally – which will be influenced strongly by the nature and level of our settlement from the forthcoming Comprehensive Spending Review.

We will consider these factors in parallel so that we understand our options around what we can deliver and how we would deliver it early in the process.

Next steps:

The delivery of the price review is a very important, albeit resource intensive tool we use to regulate the sector. Given that the price review only occurs every five years at present, it is prudent to consider the form of the delivery model to ensure that we operate as efficiently and effectively as possible.

We will develop and consider in parallel options for the PR19 policy framework and the delivery model. This will help align our ambition with our capabilities, thereby making efficient and effective use of our available resources.

4. Summary of next steps

In the table below, we summarise the next steps that we will be taking to help promote our strategic objectives. It should be noted that many of the next steps will promote multiple strategic objectives; but in the interests of brevity we do not repeat these actions.

Table 2 Summary of next steps

Strategic objective	Next steps	Responsibility
Customer-focused sector	Companies to better understand customer priorities, which could include using information generated from interactions with customers on a day-to-day basis.	Companies
	Empower the customer voice through information provision where possible, particularly comparative information.	All
	Consider how we use guidance – recognising the need to give clarity about the role of customer assurance but without shifting companies' focus back onto the regulator.	Ofwat
	Alongside our company monitoring framework and strategic assessment framework, consider how to best incentivise and give visibility to Board ownership of: • the planning phase of business plans; and • the delivery within the control period.	Ofwat
Company ownership and accountability for delivering what customers want	Consider the design of the RBR for the next price review, including: (i) whether we can make better use of reputational and procedural benefits, along with the size of the financial reward; and (ii) ensuring that enhanced status reflects both high-quality business plans, and high performance during the control period.	Ofwat
	Companies to develop a balanced package of rewards and penalties, with sufficient money at risk – to incentivise improved performance and innovation for the long-term benefit of customers.	Companies
	Provide clear, unambiguous guidance for the remaining elements of PR14 reconciliation not covered in our published rulebook, which will reduce the need for interventions.	Ofwat

Strategic objective	Next steps	Responsibility
	Maintain our approach to financeability from PR14, with a particular emphasis on company ownership and empowerment through the financeability levers.	Ofwat
The revelation of information	Explore opportunities for more targeted controls where the benefits outweigh the costs.	Ofwat
	Companies should look to improve their understanding of costs, and allocation across controls and charges.	Companies
	Improve the revelation of information by committing to adopt a policy of transparency (in relation to decisions that affect customers).	All
	Identify opportunities for efficiencies around documentation (business plans and determinations) and where possible tailor information to cater to the different interests of stakeholders.	All
Promoting a resilient sector	Companies should demonstrate how they are planning for the long term – for example, using multi-period outcomes and delivering for the long term through a focus on continuing asset health.	Companies
	Maintain our approach to financeability from PR14 with a particular emphasis on company ownership and empowerment through the financeability levers.	Ofwat
Driving value for money	Improve how wholesale costs are determined by: • developing robust data sets early in the control period so that we can refine and improve the modelling of costs; • considering whether the models are sufficiently challenging, including whether efficiency targets should reflect an element of dynamic efficiency, as well as historical upper quartile efficiency; • encouraging companies to improve the quality of analysis and evidence that underpins adjustments to cost models; and • examining whether barriers to water trading remain.	All

Strategic objective	Next steps	Responsibility
	Improve how the retail cost allowance is calculated by: • considering whether our approach at PR14 was sufficiently challenging – for example, should we adopt an 'efficient cost to serve' approach? • working with the sector to identify opportunities to simplify the modelling and reduce the regulatory burden ahead of the next price control; and • (for non-household customers in Wales) look at how we can set challenging but fair allowances.	All
	Consider how we can encourage companies to continue their focus on operational outperformance – for example, through higher powered cost and service incentives.	Ofwat
Being an efficient and effective regulator	Identify ways to make the process more efficient and less stretching for Ofwat and for companies.	All
	Consider how we can design future price review timetables to support proportionate changes, and to build in agile programme working.	Ofwat
	Companies to consider how they can be more adaptable to changing circumstances rather than sticking to rigid timetables.	Companies
	Develop and consider options for the PR19 policy framework and the delivery model.	Ofwat
	Improve how we engage by: • spreading more engagement across our Senior Leadership Team; • maintaining a Portfolio Lead contact, but reducing the volume of engagement where the price review methodology entails less cultural change; and • closing down engagement earlier in the price review process to allow more time for analysis and decision making.	Ofwat
	Use technology to reduce the cost of sharing information.	All

5. Taking it forward

This report is not a comprehensive list of all the lessons from PR14. We will still be learning about how successful totex, outcomes and ODIs are in driving efficiencies and delivering for customers as the five years of the price review period unfold. We will want to incorporate this into our future programmes of work, including the Water 2020 programme.

We will also reflect on the outcome of the referral to the CMA of the Bristol Water price determination later this year, which will be a source of further learning.

However, the information in this report will feed in to the detailed planning for our programmes of work – the Water 2020 programme, in particular.

We will engage further with stakeholders over the summer and early autumn and we hope your response will be only one part of an iterative conversation that has already started on the future reform of the regulatory model of the water sectors with such initiatives as the 'market place of ideas'. A number of water companies have contributed to this and we welcome anyone with an interest to contribute further ideas. We will also carry out a number of workshops and other forms of engagement to build on the lessons and feedback to this paper as well as the wider sector conversation. We cannot make progress alone and need the sector and everyone interested in it to work to consider the way ahead.

In October, we expect the independent "task and finish group" to publish its report on resilience.

In November as part of the Water 2020 programme we will publish:

- our approach to the review of the retail non-household price control in 2017; and
- charges scheme rules.

In December, we then plan to:

- consult on initial proposals for our approach to the regulation of water and wastewater wholesale controls at PR19; and
- publish our final approach to our resilience duty.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a leading economic regulator, trusted and respected, challenging ourselves and others to build trust and confidence in water.

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7533
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gsi.gov.uk

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