

Delivering UK Government priorities for the English water sector through our 2019 price review draft methodology

July 2017



The 2019 price review (PR19) draft methodology will play an important role in contributing to the UK Government’s strategic priorities and objectives.

The UK Government has set out [draft strategic priorities and objectives for us](#). These are due to come into effect before we publish our final methodology in December 2017.

The UK Government has grouped its objectives and priorities under three themes:

- long-term resilience;
- protecting customers; and
- making markets work.

These themes, and the objectives and priorities that underpin them, have informed the development of our PR19 methodology.

We want companies to make sure their business plans meet the needs of their customers for 2020-25 and beyond. Our PR19 methodology sets out our expectations and requirements for monopoly water companies when preparing business plans. It also outlines how we will:

- evaluate those plans, through our initial assessment of business plans; and
- set companies’ price limits, service commitments and the wider incentive framework.

Our approach to this price review is shaped by four key themes, which reflect the UK Government’s priorities and objectives:

- great customer service;
- affordable bills;
- resilience; and
- innovation.

Our PR19 themes and the UK Government’s priorities and objectives should be considered as a package rather than on a stand-alone basis. Below, we briefly outline some of the key linkages and how our price methodology reflects each of these priorities. We also discuss in more detail how our PR19 methodology reflects each of the themes of the UK Government’s priorities and objectives.

We have welcomed the involvement of a wide range of stakeholders in the development of our methodology. During the consultation period we will keep engaging with the UK Government and other stakeholders on the methodology and its contribution to the Government’s objectives and priorities.

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Our PR19 themes and the UK government priorities and objectives

	Great customer service	Affordable bills	Resilience	Innovation
Long-term resilience	✓		✓	✓
Protecting customers	✓	✓		✓
Making markets work		✓	✓	✓

Great customer service reflects the UK Government’s themes of long-term resilience and protecting customers. We expect companies to engage with their customers to identify and meet their current and future needs in a long-term, cost-effective way. This will help make sure services are sustainable, directly contributing to long-term resilience. Effective and efficient support for vulnerable customers, and those struggling to pay their bills, is also integral to great customer service.

Long-term resilience in the round includes financial, corporate and operational resilience. This reflects the UK Government’s theme of long-term resilience. Our PR19 methodology is designed to challenge water companies to plan, invest and operate to meet the needs of current and future customers in a sustainable and cost-efficient way. It also contributes to making markets work, by facilitating markets in water resources and bioresources. These will increase the range of options available to water companies, and so improve long-term resilience.

Affordable bills includes affordability for all customers, both current and future customers, as well as help for vulnerable customers and those struggling to pay their bills. This reflects the UK Government’s theme of protecting customers. Our focus on affordability is also supported by making markets work so that they deliver efficiencies to improve overall affordability, while protecting vulnerable customers.

Our focus on **innovation** reflects all of the UK Government’s themes. We are encouraging innovation and efficiency by enabling new markets in water resources and bioresources. We expect companies to innovate in a way that protects customers. For example, we encourage companies to find better ways to provide effective and efficient support to those struggling to pay their bills. We are expecting innovative plans to deliver sustainable resilience, offering the best value for money in the long term.

Incentivising companies to deliver the UK Government's priorities

We have built on our last price review in 2014. In our PR19 draft methodology, we continue to put the responsibility on water companies to own the relationship with their customers and meet their needs and requirements. Our draft methodology encourages companies wholly or mainly in England to do this in a way that also meets the UK Government's objectives.

Our PR19 methodology sets out our expectations and requirements for companies preparing their business plans to best meet the needs of their customers. It also sets out how we will assess those plans through our initial assessment of business plans and how our assessment will flow through into companies' price limits, service commitments and the wider incentive framework. Our expectations reflect the UK Government's objectives and our four key PR19 themes.

The initial assessment of business plans will test, recognise and reward high-quality, ambitious and innovative business plans. Only companies that meet our high expectations for their business plans will receive both the financial rewards available and early draft determinations of their revenue and service requirements for 2020-25.

As part of the initial assessment of business plans, we expect each company's Board to provide assurance that its business plan will comply with all statutory obligations and that it is financeable. But our assessment of plans goes wider than this: companies will need to present evidence of innovation and ambition in terms of delivering resilience and a fair deal to current and future customers. When assessing companies' business plans, we will also take the UK Government's expectations into account.

Below, we outline how our draft PR19 methodology contributes to the objectives of the UK Government.

Securing long-term resilience

Ofwat should challenge the water sector to plan and invest to meet the needs of current and future customers, in a way which offers best value for money over the long term.

When developing their business plans, we expect companies to actively engage with customers and stakeholders. This will help them to develop an in-depth understanding of customers' requirements for services, outcomes and investment, and the affordability of their plan.

Companies need to find out what matters most to their customers now and in the future – and that includes all customers, in particular those in circumstances that might make them vulnerable and hard to reach customers. To do this effectively, companies need to move from seeing customers as passive recipients of services, to seeing them as active participants in their delivery.

We expect companies to consider a full range of options and develop the solution that offers the best value for money to meet the needs of current and future customers in the long term.



Companies need to move from seeing customers as passive recipients of services, to seeing them as active participants in their delivery

Ofwat should further a reduction in the long-term risk to water supply resilience from drought and other factors, including through new supply solutions, demand management and increased water trading.

‘Long-term resilience in the round’ is one of our themes for this price review. Our seven resilience planning principles capture how companies should plan for resilience in their business plans:

- considering resilience in the round for the long term;
- customer engagement;
- broad consideration of intervention options;
- delivering best value solutions for customers;
- a naturally resilient water sector;
- an outcomes- and customer-focused approach; and
- Board assurance and sign-off.

We will assess how companies have integrated long-term resilience in the round (corporate, operational and financial resilience) into their business plans. In particular, we will test how companies have assessed and prioritised risks and chosen the best long-term solution. We expect companies to consider a wide range of options, including new supply, demand management, leakage reduction, water trading, and solutions that extend beyond traditional boundaries. For example, a company might encourage changes in behaviour through smart customer engagement, partnerships and catchment working.

Companies have a statutory requirement to help ensure operational resilience, particularly for water resources. Companies have a statutory duty to produce water resource management plans. In collaboration with the Environment Agency, Defra, Natural Resources Wales and the Welsh Government, we have developed guidance to help companies develop their water resource management plans. This encourages companies to undertake better risk based analysis, and to plan for possible future outcomes, identifying the best value solutions. We will work closely with the Environment Agency and Natural Resources Wales to provide input on WRMPs. Companies also have to produce drought plans which set out the operational actions a company will take to make sure there are supplies during periods of drought.

We expect improvements in long-term water planning for PR19. Specifically, we expect companies to integrate the development of their WRMPs into their business planning and take account of outputs from regional planning groups such as Water Resources South East and Water Resources East. This wider perspective will be particularly important to ensure best value for customers in the long term with respect to cross-company, regional and potentially national options.

Our outcomes framework, with its performance commitments, service levels, and financial and reputational incentives, supports this approach. The framework will encourage companies' management teams to identify and mitigate relevant risks to water and wastewater services and infrastructure to prevent service failures.

We are proposing 14 core common performance commitments, which apply to all water companies and cover the outcomes that matter most to customers, a number of which relate directly to water supply resilience. These will have common definitions to enable comparisons with other companies. These commitments cover:

- the quality and reliability of the water supply and wastewater services;
- customer service;
- the environment; and
- resilience and asset health.

This includes a new long-term resilience metric, developed with the sector, on the risk to customers of severe restrictions in a drought.

Ofwat should challenge companies to improve planning and investment to meet the wastewater needs of current and future customers.

There is a statutory process for water resource planning, but none for wastewater planning. As a result, long-term wastewater planning is not as advanced or transparent as water resource planning. We expect companies to demonstrate thorough and comprehensive approach to long-term wastewater planning in their business plans. This should include customer engagement to develop understanding of the needs of current and future customers.

These expectations are supported by our proposals for common performance commitments on wastewater, which include:

- customer-facing performance commitments on sewer flooding;
- options for a commitment on wastewater resilience; and
- two additional wastewater-specific asset health commitments on:
 - sewer collapses; and
 - non-infrastructure asset failure causing pollution incidents.

When making wastewater services more resilient, we expect companies to consider solutions outside traditional boundaries such as partnerships and catchment working. This should include working with other partners, such as local authorities, to plan and develop integrated solutions to surface water management.

Ofwat should work with water companies to ensure that they assess the resilience of their system and infrastructure against the full range of potential hazards and threats and take proportionate steps to improve resilience where required.

When assessing risks to long-term resilience, we expect companies' business plans to take an objective and comprehensive view of the risks they face. This should range from the risks associated with infrastructure, to those associated with systems, processes and people. It should also consider hazards and threats, such as cyber security, flooding and disruptions to energy supplies.

In line with our resilience principles, we expect companies to identify and prioritise risks to resilient services and infrastructure, assess the full range of mitigation options and propose solutions that offer the best value for money in the long term. When identifying solutions companies should engage with their customers, so that:

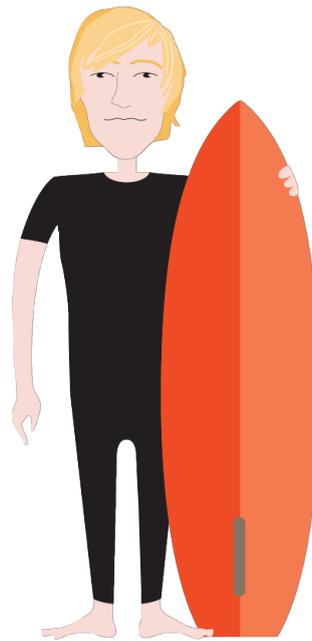
- companies consider the impact on both current and future customers;
- customers understand the risks they face and how this compares with other customers in the area and out of the area; and
- customers support for mitigations, particularly where these might involve higher bills or a change in the level of service they receive.

We require companies to have customer challenge groups (CCGs). These provide both an independent challenge to companies, and independent assurance to us on the quality of a company's customer engagement, and the extent to which this is reflected in business plans. CCGs draw on a broad range of expertise to challenge companies, including the Environment Agency and environmental non-governmental organisations. A company's CCG provides an independent report alongside the company business plan.

Ofwat should encourage the sustainable use of natural capital by water companies – that is, our natural assets such as rivers and groundwater – by encouraging water companies to have appropriate regard to the wider costs and benefits to the economy, society and the environment.

Later this year the Environment Agency and Natural England will set out their strategic requirements which will remind water companies of their statutory obligations, expectations and best practice for the sector. We expect companies to meet their statutory duties, including those on the environment and drinking water quality, both now and in the future. As noted above, we expect company Boards to provide assurance that their business plans will comply with their statutory obligations.

When going beyond their statutory obligations, we expect companies to consider implications for natural capital and engage with customers on the benefits of their proposals. This is reflected in our resilience principles, which we expect companies to follow when developing their business plans. These include considering the delivery of both the best long term value solution for customers, and a naturally resilient water sector. This means companies will need to consider ecosystem resilience and biodiversity as part of their decision-making processes. We will take natural capital impacts and customer support into account when assessing special cost claims from companies. This will be particularly important where companies' operations depend on ecosystems and the natural environment – operations like abstraction, treatment and discharges, for example.



Companies need to consider ecosystem resilience and biodiversity as part of their decision-making processes

Protecting customers

Ofwat should challenge the water sector to go further to identify and meet the needs of customers who are struggling to afford their charges.

We expect water companies to deliver affordable, value for money bills, both now and in the future. Companies will need to engage with customers to show that their plans are affordable over the short and long term. This includes considering both the level and the volatility of bills.

We will assess the effectiveness of company proposals as part of our initial assessment of business plans. Companies will also need to identify and develop effective support packages to help vulnerable customers and those who struggle to pay their bills.

This price review gives companies real opportunities to make bills more affordable and deliver great customer service and resilience, all through a step change in performance. Based on market evidence we expect financing costs to stay lower for longer. We can also see opportunities for companies to use the price control framework to make significant efficiency savings. Taken together, these should allow companies to provide customers with real choices about lowering their bills, improving resilience and quality of service.

Ofwat should challenge companies to improve the availability, quality, promotion and uptake of support to low income and other vulnerable household customers.

We will assess companies' proposals of assistance to vulnerable customers and those struggling to pay their bills.

When they develop their plans, companies will need to engage with their customers on affordability and value for money, explain how their proposals will affect different groups of customers, and gain support for their proposals. Company proposals will need to be:

- effective: they will need to improve affordability for those that require help;
- efficient: they should make a positive difference to affordability compared to the costs of interventions; and
- accessible: customers who are struggling to pay can easily get effective help and support.

We expect companies to take into account the challenges we set in our [2016 Vulnerability focus report](#). In particular, we expect companies to:

- use good quality available data to understand their customers and identify those in circumstances that make them vulnerable;
- engage with other utilities and third party organisations on vulnerability issues; and
- target efficient and effective measures to address vulnerability.

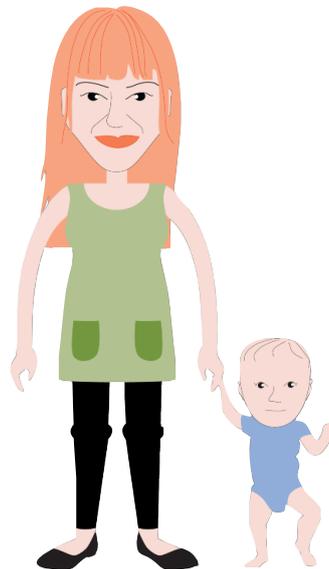
To support this, we are proposing that companies should develop and report against performance commitments on vulnerability.

Each company's customer challenge group has a key role in providing us with independent assurance on how well the company has engaged with their customers, including on affordability, and how this is reflected in business plans.

Ofwat should promote an enhanced focus by water companies on the needs of small business customers that may struggle to access the best deals.

The business, charity and public sector retail market in England opened in April 2017. Many monopoly water companies decided to exit the business retail market by transferring their business retail operations to either an associated retailer (a company in the same group), or a third party retailer. In these circumstances, customers are protected by the price and service requirements set out in the retail exit code.

Our PR19 methodology is limited to monopoly water companies. We will consider whether we need to keep providing price control protection for business customers of companies that have not exited from the retail business market. We will keep collecting information to allow us to set price controls should they be required, for example, for small business customers.



We expect companies to use good quality available data to identify those in circumstances that make them vulnerable

Making markets work

Ofwat should promote markets to drive innovation and unlock efficiencies, with the aim of furthering:

- 1. the long-term resilience of water and wastewater systems and services and/or**
- 2. the protection of vulnerable customers.**

Our PR19 methodology will promote the development of markets in water resources, bioresources (sewage sludge), and direct procurement for customers (third party delivery of large schemes). It will also enhance scope for markets in environmental services (ecoservices) by promoting innovation and the flexibility of the totex and outcomes framework. Markets improve resilience by providing a wider range and a greater choice of suppliers, leading to greater robustness.

Markets in water resources will promote water trading. This will increase the diversity of water sources a company can draw on, reducing the risk of a single point of failure and dependence on resources in a particular area. It will also increase the options available to deal with long-term pressures, such as population growth and climate change. Markets can also improve the resilience by allowing companies to target abstraction in areas of low environmental impact and reduce demand in more sensitive areas.

Markets in bioresources will encourage companies to buy services like bioresources treatment from a range of suppliers. This will increase resilience by facilitating a range of different bioresources treatment suppliers, reducing the risk of a single point of failure.

Markets will support more affordable bills because choice will encourage innovation and unlock greater efficiency. Markets in both water resources and bioresources will incentivise companies to choose the supplier with the lowest long-term costs, regardless of company boundaries. This will encourage companies to minimise the costs of supply, driving efficiency and incentivising innovation. Savings made by reducing costs can be used to

improve resilience, reduce bills for all, or provide targeted support for vulnerable customers or those struggling to pay.

Direct procurement for customers will encourage water companies to competitively tender for the financing, design, build, and operation of large projects. This can reduce the costs customers pay for the largest or most expensive new assets by increasing competitive pressure on project and financing costs, and driving innovation through greater choice.

We expect companies to consider using direct procurement for customers where competitive tendering delivers the greatest benefits for customers. Our preferred approach to direct procurement is that companies run the procurement process and manage the contractor, keeping responsibility for meeting statutory obligations. This will protect customers while maximising the benefits of direct procurement.



Markets can improve resilience by allowing companies to target abstraction in areas of low environmental impact and reduce demand in more sensitive areas

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 trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

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