

Welsh Government priorities and our 2019 price review final methodology

December 2017



The 2019 price review (PR19) final methodology will play an important role in contributing to the delivery of the Welsh Government’s priorities and objectives.

The Welsh Government can set out strategic priorities and objectives for us, which we are required to act in accordance with in carrying out our relevant functions relating wholly or mainly to Wales. Its proposed [strategic priorities and objectives](#) were laid before the National Assembly for Wales on 23 November 2017¹. In the remainder of this document, we consider these draft strategic priorities and objectives and set out how our PR19 final methodology supports the achievement of those priorities and objectives (which we refer to as the Welsh Government’s ‘strategic policy statement’).

The Welsh Government has set out six objectives for Ofwat. They set out how we should take account of the specific circumstances of Wales when developing new proposals relating to Wales. The Welsh Government has also set out its priorities for the economic regulation of the water sector in Wales² under the following seven headings:

- affordability;
- innovation;
- long-term;
- markets and competition;
- resilience;
- strong customer focus; and
- sustainable management of natural resources.

Our PR19 final methodology reflects these important objectives and priorities for Wales. Although these objectives and priorities were only published recently, the development of our methodology was informed by the Welsh Government’s [Water Strategy for Wales](#), published in 2015, and discussions with the Welsh Government on the development of the strategic objectives and priorities.

We want companies to make sure that their business plans meet the needs of their customers for 2020-25 and beyond. Our PR19 final methodology sets out our

¹ We anticipate that, unless the Assembly resolves not to approve them, they will be published in the following few weeks.

² The Welsh Government’s statement setting out strategic priorities and objectives will be issued under section 2B of the Water Industry Act 1991 in respect of Ofwat’s relevant functions relating to the areas of water undertakers and sewerage undertakers whose areas are wholly or mainly in Wales.

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.

The remainder of this document is structured as follows:

- we note the Welsh Government's jurisdiction in relation to water and wastewater and potential future changes;
- we consider the Welsh Government's objectives for us;
- we set out how our PR19 final methodology reflects each of the Welsh Government's priorities; and
- we briefly note how we will report on the Welsh Government's strategic policy statement.

Welsh Government's jurisdiction in water and wastewater

Under current legislation, the Welsh Government has jurisdiction over the activities of water companies whose areas are wholly or mainly in Wales. We have developed our PR19 final methodology to reflect this. In the future, we expect the jurisdiction of the Welsh and UK governments, in relation to water and wastewater, to be more aligned with national boundaries rather than company boundaries. This follows the recommendations of the [Silk Commission](#). The [Wales Act 2017](#) will facilitate this. Where appropriate, we have taken into consideration these potential changes in developing our thinking, but our methodology is based on the current legislative framework.

The Welsh Government's objectives for Ofwat

In this section, we note each of the Welsh Government's objectives for Ofwat that are relevant to the PR19 final methodology³, and explain how these are reflected in our PR19 final methodology.

³ The final objective states that Ofwat should submit an annual report to Welsh Ministers. This is outside the scope of the PR19 final methodology and so is not covered here.

We expect Ofwat to develop the regulatory framework as applicable to Wales on the basis of sound evidence relevant in a Welsh context. It must demonstrate how it has taken into account the specific circumstances of Wales when developing and consulting on new proposals relating to Wales. Where appropriate it should adopt a different approach for UK Government and Welsh Government regulated undertakers.

In our PR19 final methodology we have:

- quantified the benefits and costs of the key elements of our methodology separately for companies whose areas are wholly or mainly in England and for companies whose areas are wholly or mainly in Wales;
- explicitly considered the consistency of our PR19 final methodology with Welsh Government policy in the impact appraisals; and
- considered Welsh-specific evidence when developing the PR19 final methodology, for example on bad debt provision.

There are some important differences in the PR19 final methodology between England and Wales, reflecting differences in the legal framework.

- We will continue to set price controls for all water and wastewater business retail activities of Welsh water companies.
- We have not included the bilateral market entry adjustment and access pricing reporting requirements for Welsh water companies, consistent with the Welsh Government policy not to introduce this market.

We note that one company whose area is wholly or mainly in Wales, Dŵr Cymru, is owned by a not-for-dividend company limited by guarantee – this means any financial surpluses are retained for the benefit of its customers. As we explain in chapter 10 of our PR19 final methodology, we consider the combination of reputational, procedural and financial incentives we use to be appropriate to all current ownership structures and models, including that of Dŵr Cymru.

We expect Ofwat to challenge companies to deliver for customers on the basis of comparison across companies in Wales and England, and across sectors where appropriate, while making appropriate allowances for differences in the operating and legal environments of companies in Wales, and taking into account variations in the priorities of customers and other stakeholders.

The PR19 final methodology places a strong emphasis on comparisons between companies in Wales and England and therefore has the same broad price control structure across England and Wales. This will allow Welsh companies to be compared against a wider range of companies, allowing more stretching targets to be set, benefiting Welsh customers. Two areas where cross company comparisons are particularly important are:

- common performance commitments, which promote transparency and improve comparability across companies so that we, and customers, can hold companies to account – we are expecting companies to set stretching performance commitment levels for these; and
- cost benchmarking, where we will use data from all companies in our cost models to set stretching cost baselines, while taking account of legitimate differences in scale and operating environment.

Where appropriate, we will also benchmark water companies against other sectors, for example on bad debt and customer service costs.

Our PR19 final methodology emphasises the importance of companies engaging with customers and reflecting their priorities and preferences in their business plans. Through this approach we expect the business plans of Welsh companies to reflect the priorities and preferences of Welsh customers. We will test business plans on their customer engagement and reflection of customer priorities through our initial assessment of business plans.

Following our initial assessment of business plans, companies with high quality business plans with significant ambition and innovation for customers and that push the boundaries of the industry and set an example for others will be classed as ‘exceptional’ and can expect higher financial returns, as well as procedural and reputational benefits. Companies whose business plans need ‘significant scrutiny’ will face financial, reputational and procedural disincentives.

We expect Ofwat to take due account of current and future differences in both policy and law between the UK and Welsh Governments including where new obligations on water companies in Wales emerge.

Our PR19 final methodology takes account of differences in both policy and law between the UK and Welsh Governments and will continue to do so as the price review process proceeds. Our PR19 final methodology is consistent with the Welsh Government’s policy not to extend business retail competition or to introduce

upstream competition. For example, we have not included the bilateral market entry adjustment and access pricing reporting requirements for Welsh water companies. We will continue to set business retail price controls for companies whose areas are wholly or mainly in Wales.

Our PR19 final methodology requires company Boards to provide assurance that they will continue to comply with their statutory and licence obligations now and in the future. Natural Resources Wales has issued a paper, 'PR19 expectations and obligations'⁴, which sets out statutory obligations on water companies in Wales. Our PR19 final methodology and regulatory framework will help companies to manage future change to statutory obligations so that companies remain able to finance their functions, while protecting customers. Where new obligations lead to significant costs, companies can apply for an interim determination to allow price limits to be adjusted.

Ofwat should have regard to how it can enable or incentivise companies to contribute to the delivery of Welsh Government policy and strategies. Ofwat should set out clearly how any of its major decisions are consistent with the Welsh Government's strategic priorities and objectives, for example when establishing the methodology for price reviews, presenting proposals for changes to the regulatory framework such as modifications to undertakers' conditions of appointment, or publishing determinations.

This document sets out how our PR19 final methodology is consistent with the Welsh Government's strategic priorities and objectives, and how the methodology enables and incentivises companies whose areas are wholly or mainly in Wales to contribute to the delivery of the Welsh Government's policy and strategies.

Throughout our PR19 final methodology documents, we have highlighted areas where our methodology differs for companies whose areas are wholly or mainly in Wales compared to companies whose areas are wholly or mainly in England. In addition, we have considered carefully the wider context of Welsh Government policy objectives, such as those put forward in the Well-being of Future Generations (Wales) Act 2015. In terms of our PR19 final methodology, we have done this by emphasising a long-term approach to resilience, as reflected in the seven resilience principles that we expect companies to reflect in their business plans. These principles are also reflected in our advice to companies on their water resource management plans (WRMPs), which need to be designed in such a way as to not place a disproportionate share of the cost for new infrastructure, and/or upgrades to

⁴ Available from Natural Resource Wales on request.

existing infrastructure on future generations. Furthermore, the common performance commitments we are placing on companies in PR19 are designed to incentivise a long-term approach to resilience.

Ofwat should consider the clarity and cohesion of its regulatory framework taken as a whole and in a specific Welsh context. Ofwat should have regard to the desirability of a simple, effective and efficient regulatory framework. Ofwat should seek to maintain a transparent regulatory framework that allows companies, investors and customers to plan for the long term, whilst incentivising efficiency improvements.

Our PR19 final methodology reflects our [enduring price control principles](#), which we set out at the last price review. These principles include the better regulation principles of targeted price controls, proportionate price setting, effective incentives, and transparency and predictability. As part of our impact assessment we have assessed our PR19 final methodology against these principles. Our PR19 final methodology sets out in detail our approach to setting price controls for PR19 including the financial and associated models and data tables.

How our PR19 methodology reflects each of the Welsh Government's priorities

In this section, we set out how our PR19 final methodology reflects each of the Welsh Government's priorities in turn.

Affordability

We expect Ofwat to consider both current and future affordability in the design of its regulatory framework. Ofwat should incentivise companies to continuously seek efficiency gains to deliver more for less in order to improve the value for money of water and sewerage services, having regard to resilience and service over the long term. We expect social tariffs to be available for those who struggle to pay, reflecting the views of the generality of customers. We also expect Ofwat to support appropriate efforts by companies to meet the challenge of managing customer debt and minimising write-offs so as to minimise the impact of bad debt on other customers' bills.

The PR19 final methodology gives companies opportunities to make bills more affordable and to deliver great customer service and improve resilience. Based on market evidence, we expect financing costs to be lower for PR19. We can also see opportunities for companies to use the price control framework to make significant efficiency savings.

- We will implement sharper cost sharing incentives to submit and deliver efficient business plans.
- We will benchmark companies (within the sector, and against other sectors, where appropriate) to assess cost efficiency and set efficient and stretching cost baselines.
- Our stronger challenges on companies' service quality through our outcomes assessment will promote value for money.

Taken together, these measures should allow companies to provide customers with value for money and lower bills, while improving resilience and the quality of service.

We have made affordability a key theme for PR19. As part of our initial assessment of business plans, we will consider the extent to which water companies will deliver affordable, value for money, bills both now and in the future and address affordability for those struggling, or at risk of struggling, to pay. We expect companies to engage with their customers to understand what affordability looks like for them and to develop plans that are affordable over the short and long term – this includes considering both the level of, and changes in, bills.

We expect companies to offer a range of assistance options, including social tariffs, and be more proactive getting customers who struggle, or are at risk of struggling, to pay their bills onto those assistance options. We will be examining this in our assessment of company business plans. The Welsh Government issued guidance in 2013 to Welsh water companies and Ofwat on social tariffs. We must have regard to this. Some social tariffs are revenue positive for companies because they reduce bad debt. But we will expect to see strong evidence that customers are supportive of social tariffs that go beyond revenue neutral levels of assistance and that the assistance is provided in the most efficient way.

We will test companies' proposals on affordability against five principles (customer engagement, customer support, effectiveness, efficiency and accessibility for customers who are struggling to pay).

The CCGs will provide us with independent assurance on how well each company has engaged with its customers on affordability, and how well this is reflected in the company's business plan.

Customers should not pay for bad debt that is a result of poor revenue recovery and debt management practices. In its July 2013 consultation on bad debt in the water industry in Wales, the Welsh Government noted that the cost of debt from the non-payment of water bills is borne by all paying customers, and in Wales this currently adds approximately £20 per year to each bill⁵. We commissioned PwC⁶ to consider water companies' relative cost performance in debt management and customer services both within the sector and across sectors to identify best practice.

We will consider the efficiency of retail costs and the approach to levels of bad debt in our initial assessment of business plans. We expect companies to demonstrate that their revenue recovery and bad debt management costs and practices are in line with best practice. Companies are required to outline how their proposed approach will enable them to become more efficient and deliver improvements for customers.

We have also put in place measures to encourage water companies to tackle gap sites (where water and/or wastewater services are being consumed, but the property is not on a water company's system and is therefore not billed) and voids (properties that have been classed as vacant) more effectively. If not addressed both of these can increase customers' bills.

Innovation

Ofwat should incentivise companies to seek new ways of delivering services for customers and the environment more efficiently, on the basis of sound evidence and research. An example would be developing markets for ecosystem services where these are based on robust economic and scientific evidence and have considered the polluter pays principle. Ofwat should encourage the use of catchment approaches which recognise the value of wider partnerships and the involvement of landowners, farmers and other stakeholders in delivering improvements.

We have made innovation one of our four key themes for the PR19 final methodology. It is also one of three key characteristics, along with ambition and high quality, that we will assess company business plans against as part of our initial assessment of business plans. We expect companies to demonstrate ambition and

⁵ [Tackling bad debt within the water industry in Wales: consultation - summary of responses](#), August 2014.

⁶ Retail Services Efficiency, PriceWaterhouseCoopers, 28 September
<https://www.ofwat.gov.uk/regulated-companies/vulnerability/debt-management-and-other-retail-costs-research-and-recommendations/>

innovation throughout their plans, including how they will innovate to deliver affordability, resilience and great customer service.

Only high quality, ambitious and innovative business plans will be able to be judged as exceptional and receive financial, procedural and reputational benefits. To assist companies we have published '[driving innovation in water](#)' alongside our PR19 final methodology which sets out good practice in relation to innovation.

The initial assessment of business plans will also test companies' ability to innovate by examining whether they have the right culture for innovation and whether they are able, through their systems, processes and people, to deliver results for customers and the environment from innovation.

The total expenditure (totex) and outcomes framework will facilitate innovation by making clear the outcomes that companies are expected to deliver, while providing companies with the flexibility on how they deliver them. Companies will have strong financial incentives during the price control period to deliver the outcomes required by customers at the lowest costs, driving innovation. Outcome delivery incentives will reward companies that deliver frontier-shifting service improvements for their customers – and penalise companies who do not keep up. The focus on outcomes rather than outputs, and support for the natural capital approach (where appropriate), will help reduce the barriers to collaborative catchment management solutions and markets for environmental services, consistent with the Welsh Government's [Water Strategy for Wales](#). This will facilitate companies in reaching agreements with abstractors and polluters, to improve the quality of the ecosystems in which they operate. It will also avoid some of the costs associated with developing new water sources, or treating polluted water. This will be reinforced through our initial assessment test on resilience, which requires companies to consider the full range of mitigation options. Within this, we expect companies to consider catchment management and sustainable drainage schemes.

Long-term

We expect Ofwat to consider the appropriate balance between short-term affordability and the need to safeguard longer-term affordability, resilience and performance. The regulatory framework should seek to ensure that companies do not delay appropriate investment in the short term to the detriment of the interests of future customers. Assets should be monitored and maintained appropriately to ensure that the costs borne by future bill payers are efficient. We expect companies to have long-term planning frameworks for both water and wastewater. Ofwat should encourage and incentivise long-term planning by companies to protect against anticipated future social, economic, and environmental challenges, while taking advantage of technological innovations.

Our PR19 final methodology will require companies to consider the appropriate balance between short-term affordability and long-term affordability, resilience and performance. We want to see companies being fair to future generations, as do customers. Our PR19 final methodology is clear that companies should make appropriate decisions about investment and costs to make sure they are not storing up problems for subsequent price control periods and future customers, consistent with the sustainable development principle set out in the Well-being of Future Generations (Wales) Act 2015.

In the initial assessment of business plans we will test the companies' proposals for the overall affordability of bills as well as affordability over the long term.

Our initial assessment of business plans will test companies' proposals on resilience with the following tests:

1. How well has the company used the best available evidence to objectively assess and prioritise the diverse range of risks and consequences of disruptions to its systems and services, and engaged effectively with customers on these risks and consequences?
2. How well has the company objectively assessed the full range of mitigation options and selected the solutions that represent the best value for money over the long term, and have support from customers?

In assessing risks, we expect companies to take account of social, economic and environmental challenges. We also expect companies to take account of wider water and wastewater planning. Planning for clean water services, including statutory

WRMPs (which cover a 25 year period), has a well-developed framework. This enables companies to assess pressures and risks objectively and effectively engage with customers. As a statutory consultee in relation to WRMPs, we play an active part in the process, and they are an important input into the development and review of business plans for PR19.

There is a statutory process for water resources planning, but none for wastewater planning. As a result, long-term wastewater and drainage planning is not as advanced or transparent as water resources planning. One of the recommendations of our [Resilience Task and Finish Group](#) was that each company should have a wastewater and sewerage plan. As part of our initial assessment of business plans, we will assess the extent to which these plans demonstrate consideration of long-term operational resilience. We will assess the extent to which companies have demonstrated an ambitious, transparent and comprehensive approach to long-term wastewater and drainage planning in their business plans. We expect companies to develop their drainage strategies by applying the [drainage strategy framework](#) best practice guidance. They should also draw upon tools developed as part of the Water UK-led 21st century drainage programme and the developing framework for drainage and wastewater management plans.

We will consider, as part of our initial assessment of business plans, the extent to which companies consider drainage solutions outside traditional boundaries to make wastewater services more resilient. We expect companies to consider the role of partnerships, catchment management and other softer options in combination with fixed asset based solutions. They should demonstrate working with others, particularly local authorities and internal drainage boards, to plan and develop integrated solutions to surface water management; encourage and facilitate sustainable drainage systems; and cooperate to manage broader flooding risks. We have taken particular note of the effective and early promotion by the Welsh Government of payment for ecosystem services schemes, and we actively encourage companies to work with local partners to replicate and scale such schemes.

In addition, our outcomes framework, with its performance commitments and financial and reputational incentives on issues such as asset health, supports long-term planning for both water and wastewater services. We are requiring companies to set projections for their performance commitments for at least ten years beyond 2025, to encourage a long-term approach in business plans.

Ofwat must work with the Drinking Water Inspectorate to regulate companies to encourage and incentivise them to maintain the current high standard of public drinking water quality for the long term. This should include customer acceptability as well as wholesomeness.

The quality of drinking water is a high priority for customers. Our PR19 final methodology includes a common performance commitment on the quality of the water supply, the compliance risk index, which the Drinking Water Inspectorate has developed in consultation with the industry.

Markets and competition

The Welsh Government recognises the potential role that markets can sometimes play in raising performance standards and driving efficiency. However, Ofwat should ensure that its regulatory approach is consistent with Welsh Government policy on retail competition and upstream competition. Ofwat's regulatory approach to markets should seek to ensure that there is a level playing field between new entrants and existing undertakers. Further, Ofwat should not seek to introduce competition where the activity of new entrants would reduce undertakers' overall accountability for the delivery of excellent services to customers and the environment, and threatens the integrity and efficiency of the management of the network systems as a whole. Ofwat should not move towards the de-averaging of network charges for end users, based on the cost of providing them with water and sewerage services to their geographic location.

Our regulatory approach is consistent with the Welsh Government's policy not to extend retail competition or introduce upstream competition.

The Welsh Government has decided not to introduce upstream competition. The bilateral market model for water resources that we are putting in place for companies whose areas are wholly or mainly in England will therefore not apply to incumbent companies whose areas are wholly or mainly in Wales.

However, the promotion of markets, where appropriate, can help to achieve other priorities of the Welsh Government such as affordability, innovation, resilience and a strong customer focus. Our PR19 final methodology will promote the development of

markets in Wales, to the extent that this is consistent with Welsh Government policy, in the following areas:

- ecoservices (environmental services);
- water resources;
- bioresources (sewage sludge); and
- if appropriate, direct procurement for customers (third party delivery of large schemes).

We will ensure transparency to facilitate the development of markets. For example, in water resources and bioresources, we will require water companies to publish market information to address the lack of supply side information on sludge production and water supply demand deficits. This will help to ensure a level playing field between new entrants and incumbents.

Direct procurement for customers will, where appropriate, enable 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. Whether direct procurement for customers is ultimately applied or not, companies are likely to improve outcomes by considering and evaluating alternative options.

We expect companies to consider using direct procurement for customers where competitive tendering delivers the greatest benefits for customers. Companies are not expected to take forward direct procurement for customers where the additional costs would outweigh the benefits. We consider that direct procurement is likely to have the greatest benefits where projects are discrete in terms of minimising the number of interactions with the rest of the network, and risks are well understood. This will minimise the risk to the integrity and efficiency of the management of network systems as a whole. Water companies will remain accountable for their statutory and licence obligations and so will remain accountable for the delivery of excellent services to customers and the environment.

Resilience

Ofwat has a key role to play in the delivery of a resilient water sector. Ofwat's approach and regulatory framework should encourage, enable and incentivise resilience both in regard to short and long-term challenges. Companies are responsible for ensuring their assets and the services they provide are resilient against natural hazards and other problems that can be reasonably anticipated and that their services are resilient against asset failure and other threats including cyber-attacks. Ofwat should encourage and incentivise companies to maintain and enhance the resilience of ecosystems and the benefits they provide in the delivery of their functions, and in so doing, meet the needs of present generations without compromising the ability of future generations to meet their needs.

We have made resilience one of our four key themes of the PR19 final methodology. We expect companies to apply our seven resilience planning principles in their business plans.

Resilience planning principles

Principle 1: Considering resilience in the round for the long term. Companies should show a systematic and integrated understanding of service and systems risk, across the entire business, considering short, medium and long-term risks.

Principle 2: A naturally resilient water sector. Companies should promote ecosystem resilience and biodiversity as a key part of the decision-making process for ensuring resilient services where this is consistent with companies' role as providers of water and wastewater services.

Principle 3: Customer engagement. Aspirations on levels of resilience should be informed by engagement with customers, to help companies understand their customers' expectations on levels of service.

Principle 4: Broad consideration of intervention options. Companies' plans to manage resilience should consider a full set of mitigating actions and interventions that consider all components of resilience, including response and recovery.

Principle 5: Delivering best value solutions for customers. Companies' plans to manage resilience should consider the best-value solutions for customers in the long term, which may involve long-run solutions.

Principle 6: Outcomes and customer-focused approach. Companies' plans to manage resilience should inform the outcomes they propose.

Principle 7: Board assurance and sign-off. Companies' Boards will need to assure us that their business plans are informed by a robust and systematic assessment of the resilience of the company's systems and services. This means incorporating customers' views and comprehensively and objectively assessing customers' long-term interests.

We will test companies' adherence to these principles through our resilience tests in our initial assessment of business plans, which we set out above.

In line with principle 1, we expect companies to consider resilience to short, medium and long-term risks. When assessing risks we will test whether companies have considered a full range of risks including risks associated with infrastructure and assets to those associated with systems, processes and people. Companies should consider the full range of potential hazards and threats that could impact on service provision such as natural hazards and other problems that can be reasonably anticipated, including flooding of water and wastewater infrastructure, burst water mains or other asset failures or physical or cyber-attacks.

In line with principle 2, promoting ecosystem resilience and biodiversity is a key part of the decision-making process for ensuring resilient services, where this is consistent with companies' roles as providers of water and wastewater services. Companies will need to deliver environmental schemes where they have a legal duty to do so. Or where, consistent with the company's role as providers of water and waste water services, it is the best value way of delivering an outcome in line with customers' preferences and priorities, and is affordable.

Our outcomes framework, with its performance commitments and financial and reputational incentives, will encourage companies' management teams to identify and mitigate relevant risks to water and wastewater services and infrastructure to prevent service failures. There will be 14 core common performance commitments, which cover a range of issues including resilience and asset health. As part of our challenge to companies on resilience, we are introducing two new forward-looking common performance commitments for resilience: the risk of severe water supply restrictions in a 1-in-200 year drought and the future risk of flooding in a 1-in-50 year

storm. Companies need to propose stretching levels for their resilience performance commitments, following engagement with their customers and stakeholders.

Strong customer focus

We expect Ofwat to incentivise companies to engage effectively with customers and stakeholders and deliver what customers want, having regard to the possibility that different customers may have different priorities, including vulnerable customers. Companies should demonstrate that their business plans are acceptable and affordable having regard to both their existing and future customers. Ofwat should also encourage companies to communicate effectively with their customers and increase customer involvement where customer behaviour can help reduce operating problems and increase efficiency.

We have made great customer service one of four key themes of our PR19 final methodology. When operating their businesses, and developing their business plans, we expect companies to actively, meaningfully and effectively engage with their customers and stakeholders. This will help them to develop an in-depth understanding of customers' preferences for services, outcomes and investment, and of the affordability of their plan over the long term. As part of our PR19 final methodology, we have established a number of principles underlying good customer engagement. Among other things, these principles state that:

- companies should involve customers in service delivery including through customer participation;
- companies should understand the needs and requirements of different customers including customers in circumstances that might make them vulnerable; and
- companies should engage on longer-term issues such as resilience, security of services and the long-term affordability of bills.

Through our initial assessment of business plans, we will test the quality of companies' customer engagement, including their approach to customer participation and how well their customer engagement has been reflected across their business plans. We will also require assurance from company Boards that their business plans have been informed by customer engagement. Customer challenge groups (CCGs) will provide independent challenge to companies and provide

independent assurance to us on: the quality of companies' customer engagement; and the degree to which this is reflected in their business plans.

Two of our 14 common performance commitments directly relate to customer experience, with one commitment on residential retail customers' experience and one on developer services customers' experience. Our customer measure of experience (C-MeX) will include the experiences not only of customers who contact their companies, but also of customers who do not, so that companies are incentivised to deliver for all their customers. The new developer services measure of experience (D-MeX) will incentivise companies to deliver excellent customer service to new connections customers.

Welsh companies must have at least one bespoke performance commitment on the quality of the retail services they provide for their business customers.

Sustainable management of natural resources

The Welsh Government recognises the need for a more integrated approach to managing our natural resources, including through whole catchment approaches. Ofwat should encourage and incentivise the sustainable and efficient use of water resources, including by encouraging companies to reduce leakage and consumption where it is cost effective to do so. Ofwat should encourage and incentivise companies to manage wastewater and surface water in an integrated and sustainable way. Companies should be incentivised to seek solutions which deliver wider benefits to society and the environment, where this is justified by sound evidence.

The importance of investing in natural resources and making our ecosystems more resilient is recognised by Natural Resource Wales's [State of Natural Resources Report](#) and Welsh Government's [Water Strategy for Wales](#).

As part of our initial assessment of business plans, we will consider the extent to which companies:

- plan and invest appropriately to meet their statutory duties, and go beyond these where it is consistent with the companies' roles as provider of water and wastewater services and is the best way of delivering an outcome in line with customers' preferences and priorities, and is affordable;

- consider ecosystem resilience and biodiversity as part of their decision-making processes – a naturally resilient water sector is one of our resilience planning principles which we emphasised in our ‘resilience in the round’ document – companies’ consideration of their impact on the environment will be particularly important where companies’ operations depend on ecosystems and the natural environment, for example, abstraction, treatment and discharges;
- have based their business plans on thorough analysis of their long-term water resources position through the WRMP process; and
- show that they have analysed the costs and benefits of their investment choices, including the wider costs and benefits to the economy and society, having engaged with customers to understand their views.

The natural capital approach provides an opportunity for the value of ecosystems to be better incorporated within the evaluation of resilience and, where appropriate, could be incorporated into the assessment of the impact of companies’ activities.

Our 14 core common performance commitments apply to all water companies and cover the outcomes that matter most to customers, including the environment, resilience and asset health. These common performance commitments will promote transparency and improve comparability across companies so that we, and customers, can hold companies to account. Many of these common performance commitments relate to the sustainable management of natural resources – for example, pollution incidents, per capita consumption and leakage. We are expecting companies to set stretching performance commitment levels for these, which should reduce the impact of water companies on the environment. Leakage reduction is an area where we expect to see both ambition in each company’s plan for its customers, and innovation in how it is delivered. We will require companies to justify their proposals against our challenges. These challenges include a 15% reduction by 2025 or upper quartile performance on leakage per property per day throughout the 2020-25 period.

We are requiring companies to have comprehensive coverage of their environmental challenges in their bespoke performance commitments and to take into account customers’ preferences and, where appropriate, the environment, biodiversity and natural capital when setting their performance commitment levels and outcome delivery incentives.

These bespoke environmental performance commitments will sit alongside the abstraction incentive mechanism (AIM), on which all companies must have a bespoke performance commitment. The AIM incentivises water companies to reduce

the environmental impact of abstracting water at environmentally sensitive sites during defined periods of low surface water flows.

Reporting on the Government's strategic policy statement

In due course, we will inform the Welsh Government how we propose to report on how we are meeting the expectations of its strategic policy statement. Our forthcoming forward work programme and annual report will also be accompanied by an explanation of our efforts to further the priorities and objectives of the Welsh Government for the water sector.

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.

Mae Ofwat (yr Awdurdod Rheoleiddio Gwasanaethau Dŵr) yn adran llywodraeth anweinidogol. Rydym yn rheoleiddio'r sector dŵr yng Nghymru a Lloegr. Ein gweledigaeth yw bod yn rheoleiddiwr yr ymddiriedir ynddo ac a berchir, bod yn flaengar a herio ein hunain ac eraill er mwyn meithrin ymddiriedaeth a hyder mewn dŵr.

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Printed on 75% minimum de-inked post-consumer waste paper.
December 2017

ISBN 978-1-911588-22-1

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