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PR14 review – call for input

Ofwat

About this document

This call for input document seeks to capture views, experiences and evidence on the impact of the 2014 price review (PR14) on the water sector.

Responses to this call for input should be sent to pr14review@ofwat.gov.uk by Friday 8 January 2021.

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1. Introduction

The 2014 price review (PR14) marked a new regulatory approach for the water sector. We set out a framework that encouraged companies to proactively engage with customers, and to focus on delivering the services that matter most to customers and the environment in the most efficient way.

As the PR14 period has now ended we want to review the impact it has had on the sector. This reflects our ambition to increase our focus on ex-post analysis and evaluation of our policies in order to increase our future impact. This review will, in particular, help us to improve the design of the 2024 price review (PR24) and other future price reviews.

We published [‘Reflections on the price review’](#) shortly after PR14 final determinations which set out sector views on the PR14 process. We do not intend to duplicate those findings, but rather to focus on what can be learnt from the PR14 period itself. We would like to evaluate if key elements of PR14:

- achieved their original objectives;
- resulted in any unintended effects (positive or negative);
- are still valid for future price reviews; and
- could be made more effective in future price reviews.

We will draw on existing publications, some of which have already informed our approach to the 2019 price review (PR19).¹ In addition, we will consider data such as the annual performance report (APR) data submitted throughout the PR14 period. But we would also like to capture your views and experiences of the PR14 period, along with any supporting evidence you may be able to provide, through this call for input on PR14.

To assist with this we have developed a series of questions grouped by each of the objectives for PR14 set out in our methodology, followed by a question on the PR14 reconciliation mechanism and some more general questions. The objectives of PR14 were:

- **Separate controls** to set more effective incentives for the value chain and support and facilitate the development of the competitive market for retail services in England;
- Encourage greater **focus on delivery** and on the outcomes customers want;

¹ For example – KMPG and Aqua Consultants, [Innovation and efficiency gains from the totex and outcomes framework](#), June 2018; PwC, [Refining the balance of incentives for PR19](#), June 2017 and Ofwat, [Out in the cold – Water companies response to the ‘Beast from the East’](#), June 2018.

- Secure the best **value for money** for customers;
- Encourage more **sustainable use of water resources**; and
- **Balance risk and return** fairly between customers, companies and their investors.

Please send your response on behalf of your organisation to pr14review@ofwat.gov.uk by Friday 8 January 2021.² If you have any queries or are unable to respond by the date above, please contact pr14review@ofwat.gov.uk.

We are aiming to publish our PR14 review findings in April 2021 for discussion.

² We do not intend on publishing the full responses we receive as part of this call for input. A high level summary of your response may be included in our PR14 review findings which we are aiming to publish in April 2021, unless you indicate that you would like your response to remain unpublished. Information provided in response to this call for input, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the General Data Protection Regulation 2016, the Data Protection Act 2018, and the Environmental Information Regulations 2004. For further information on how we process personal data please see our [privacy policy](#). If you would like the information that you provide to be treated as confidential, please be aware that under the FoIA there is a statutory [Code of practice](#) which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

2. Separate controls

At PR14 we set separate wholesale and retail controls for the first time.

For wholesale services we set separate binding total revenue controls for wholesale water and wholesale wastewater services. Through the separation of wholesale controls we intended to:

- allow distinct cost and delivery incentives between water and wastewater services. This better targeting of cost assessment and cost performance incentives was expected to deliver efficiency benefits; and
- support future upstream market reform by improving the transparency of costs and revenues in separate parts of the wholesale value chain.

For retail services we set separate controls for household and non-household services, respectively. For the household retail, we set a total revenue control. For non-household retail, an average revenue control applied, with different levels for different customer types (which were then re-set at PR16, prior to the non-household retail market opened in April 2017). The use of an average rather than total revenue control was intended to provide companies with strong incentives to compete for customers and deliver efficiencies (as a company which loses customers cannot simply increase its tariffs in order to recover the same revenue under an average revenue control).

By setting separate retail controls we intended to:

- allow better targeted incentives for retail parts of the business that are distinct from those that apply to the much larger wholesale part of the business;
- increase the likelihood that retailers would place efficiency pressures on wholesale businesses; and
- for those companies operating wholly or mainly in England, support and facilitate the development of the proposed competitive market for retail services to non-household customers.

We have separately considered the development of the non-household retail market since its opening in April 2017,³ and we do not intend to evaluate the market performance as part of this review, other than the extent to which the PR14 price

³ See <https://www.ofwat.gov.uk/regulated-companies/markets/business-retail-market/market-performance/>

control impacted on it. Some of the work already conducted on the business retail market may be informative in this respect.⁴

We also set a separate control for Thames Water for Thames Tideway. We are not intending to evaluate this control as part of this review.

Questions

1. To what extent did separating controls improve understanding and transparency of costs in different parts of the value chain (ie wholesale water and wastewater; retail business and residential)?
2. How effective were the controls at supporting the development of the business retail market for customers of companies operating wholly or mainly in England?
3. Do you have any other feedback on this objective?

Please provide any evidence and/or examples you may have from your experience of PR14 to support your answers.

⁴ For example [future protections for business retail customers: Decision on Retail Exit Code – price protections](#) considered the extent to which the PR14/16 controls were reflective of business retailing costs.

3. Focus on delivery

At PR14, we moved from an outputs to an outcomes based approach. We placed a much greater emphasis on customer engagement than in previous price reviews, requiring companies to engage with their customers to determine which service delivery outcomes are most important to them. Companies then had to reflect this in their business plans as a package of performance commitments. This is in contrast to previous price reviews where business plans consisted of regulatory outputs (and associated schemes) that companies' would seek funding to deliver.

Service delivery for customers was incentivised via a package of outcome delivery incentives (ODIs) associated with each performance commitment, where a company demonstrated that financial incentives were appropriate. Underperformance payments incentivised companies to meet their performance commitments and provided compensation to customers in the event that they did not. Where a company could further demonstrate that there was a benefit to customers from performance over and above the committed level, outperformance incentives were also applied.

The outcomes framework intended to:

- encourage companies to create plans for the 2015–20 period that focused on delivering the outcomes customers value most at a price they are willing to pay (as opposed to the delivery of schemes or regulatory outputs);
- improve incentives for companies to deliver by better aligning the incentives of shareholders with customers and the environment;
- encourage greater ownership and accountability by companies for delivering their plans;
- give flexibility to companies to deliver for their customers using the most efficient solution. This provided greater freedom to innovate encouraging dynamic as well as productive efficiency benefits. This contrasted with the previous price review outputs based approach in which companies committed to delivering specific schemes ex-ante; and
- reduce the administrative burden on companies and Ofwat.

To ensure appropriate independent challenge, each company was required to establish a Customer Challenge Group, consisting of representatives of consumer and stakeholder groups, whose purpose was to challenge the company on and report to Ofwat on:

- the quality of their customer engagement; and
- how well the proposed outcomes, performance commitments and delivery incentives reflect this customer engagement and wider consumers' views and priorities.

Questions

4. To what extent did PR14 performance commitments reflect outcomes rather than outputs?
5. To what extent did the PR14 outcomes reflect customer priorities throughout the period?
6. Did the outcomes framework impact on the way companies contracted with the supply chain during 2015-20?
7. Did the outcomes approach affect the way companies operated during 2015-20 in other ways?
8. To what extent did the performance commitment levels set accurately reflect the stretch that could be achieved with allowed totex? Did you observe any differences between comparable and bespoke performance commitments (or any other performance commitments)?
9. Were financial incentives effective in incentivising companies to improve performance? Where were financial incentives:
 - a. most effective and why; and
 - b. least effective and why?
10. Were reputational incentives effective in incentivising companies to improve performance? Where were reputational incentives:
 - a. most effective and why; and
 - b. least effective and why?
11. What impact did caps, collars and deadbands have on the management of risk and performance? Where were they:
 - a. most effective and why; and
 - b. least effective and why?
12. To what extent did CCGs ongoing involvement during the PR14 period help companies to focus on delivery for customers?
13. Overall, to what extent did PR14 encourage a greater focus on delivery of outcomes customers wanted, during 2015-20 and longer term?
14. Do you have any other feedback on this objective?

Please provide any evidence and/or examples you may have from your experience of PR14 to support your answers.

4. Value for money

At PR14 we moved from an approach where capital expenditure (capex) and operating expenditure (opex) were assessed separately to a total expenditure (totex) wholesale cost allowance approach. This formed part of the move from outputs to outcomes, as it allowed companies more flexibility to deliver customer outcomes in the most efficient way. It was, in particular, designed to address a potential capex bias and thereby incentivise more opex solutions, including nature based solutions.

Totex allowances were modelled for water and wastewater. These covered both base (day-to-day) costs and enhancement costs (network improvements). For water, a range of econometric models were used, some included enhancement costs and some focused solely on base costs. For wastewater, the econometric models only included base costs. Enhancement costs were modelled using benchmarking methods (eg unit cost and simple econometric modelling) for some activities, and for the other ‘unmodellable cost’ activities either the minimum of a fixed amount (proportional to the company’s totex) or the amount requested by the company were allowed. ‘Deep dives’ were initiated in specific circumstances, mainly in response to cost adjustment claims related to atypical costs.

To support efficient investment, we allowed companies to bring forward investment from 2015–20 to 2014–15 without being penalised by the Capital Incentive Scheme (CIS) which applied to the 2010–15 period.

Questions

15. To what extent did the move to a totex approach at PR14 encourage more efficient delivery solutions? Was there a more efficient balance of capex and opex expenditure during the 2015–20 period? How did it compare with what was forecast?
16. Did companies make use of the option to bring forward investment to 2014–15? Was this option helpful?
17. How well did the PR14 econometric models assess the efficient level of base costs for water and wastewater?
18. How well did the PR14 approach to assessing enhancement costs work? Were there any notable differences for different categories of expenditure?
19. Overall, to what extent did PR14 deliver value for money for customers?
20. Do you have any other feedback on this objective?

Please provide any evidence and/or examples you may have from your experience of PR14 to support your answers.

5. Sustainable use of water resources

At PR14 we included several mechanisms to encourage better use of water.

We provided companies with enhanced ‘water trading’ incentive to engage in the supply and purchase of bulk water supplies. In particular we allowed exporters to retain 50% of lifetime economic profits from qualifying water trades (i.e. over and above the allowed return on capital) by incorporating them into totex baselines in future price reviews. Furthermore we allowed importers an additional 5% of the costs of water imported in their allowed expenditure.

We also included an abstraction incentive mechanism to incentivise companies in water stressed areas to reduce levels of abstraction at low flows from environmentally sensitive sites. Some companies put forward performance commitments relating to water use, such as leakage and per capita consumption. By incentivising sustainable use of water resources we intended to:

- encourage companies to identify and achieve efficiencies by delivering lower cost opex solutions compared to new water resources capex solutions;
- increase resilience by redistributing water from more plentiful to more scarce areas;
- improve water use efficiency through the introduction of water efficiency performance commitments;
- deliver environmental benefits associated with reducing abstraction from over utilised water resources; and
- deliver environmental benefits by reducing greenhouse gas emissions associated with alternative water resource solutions such as desalination.

Questions

21. To what extent did the water trading incentives encourage companies to look for opportunities to trade water?
22. To what extent did the abstraction incentive mechanism encourage companies to reduce abstraction in water stressed areas?
23. To what extent did the water efficiency performance commitments encourage companies to make better use of water?
24. Overall, to what extent did the PR14 approach encourage more sustainable use of water resources?
25. Do you have any other feedback on this objective?

Please provide any evidence and/or examples you may have from your experience of PR14 to support your answers.

6. Balance of risk and return

For wholesale controls, we continued to allow a return on regulatory capital value (RCV) based on our estimate of the weighted average cost of capital (WACC). While our use of the capital asset pricing model (CAPM) to set the allowed return on equity marked continuity with previous price reviews, we used a benchmark index (the iBoxx A/BBB) for the first time to inform the allowed cost of debt. We remunerated the cost of capital in the newly-created retail controls using a net margin approach rather than setting a WACC.

Our approach to financeability asked companies to provide board assurance on their financeability, to set out their target investment grade credit rating and associated credit ratios. Companies were newly able to make proposals on cost recovery (i.e. PAYG rates and RCV run-off) – including where this could have a beneficial impact on financeability constraints. Companies were however required to demonstrate that their proposals were in the interests of current and future customers.

We also took a more systematic and quantitative approach to analysing how companies managed their risks and how material these were. A scenario modelling based approach was applied to analyse the overall balance of risks to companies' return on regulated equity (RoRE). We also required companies to report on their performance in RoRE terms on an annual basis throughout PR14.

To mitigate concerns about companies using higher gearing to outperform the notional cost of capital and adversely impacting on financial resilience, we introduced a financial structure monitoring regime. The rationale behind the regime was to allow us to assess industry financial resilience and the risks to customers from companies' financial structures.

Questions

26. Do you think PR14 struck the right balance of risk and return between customers, companies and their investors?
27. How, if at all, did the new approach to setting the cost of debt affect company financing decisions over 2015–20?
28. Was greater flexibility around cost recovery (PAYG or RCV run off rates) beneficial in terms of promoting financeability – or more widely?
29. How did our approach to financeability impact on company behaviour during the PR14 period?
30. Was the PR14 RoRE analysis helpful in understanding the overall balance of risk and return? Was the information reported by companies and Ofwat in 2015–20 on actual performance on a RoRE basis an effective way of measuring and understanding company performance against the final determinations? Could it have worked better?
31. Were there any ex-post areas of PR14 where companies were assigned risks inappropriately or were exposed to too much or too little risk?
32. To what extent did the introduction of the financial monitoring regime at PR14 reduce the risks posed to customers by financial structures?
33. Do you have any other feedback on this objective?

Please provide any evidence and/or examples you may have from your experience of PR14 to support your answers.

7. PR14 reconciliation mechanism

We set out our approach to reconciling companies' 2015–20 performance against the PR14 final determinations in the PR14 reconciliation rulebook.⁵ The rulebook set out how the mechanisms to make adjustments to revenue and RCV to reflect company performance would work. These were:

- outcome delivery incentives (ODIs);
- the residential retail service incentive mechanism;
- wholesale total expenditure (totex) sharing;
- wholesale revenue forecasting incentive mechanism (WRFIM);
- PR09 reconciliation (blind year adjustments);
- household retail customer number adjustment;
- water trading incentives; and
- land sales.

Question

34. How well did the PR14 reconciliation mechanisms work?

Please provide any evidence and/or examples you may have from your experience of PR14 to support your answers.

⁵ Ofwat, '[PR14 reconciliation rulebook](#)', December 2017.

8. General PR14 questions

Questions

35. What do you think the main successes of PR14 were?
36. Are there any specific areas of PR14 that you think should be improved for future price reviews?
37. Based on your experience of PR14, are you aware of any unintended effects (positive or negative) from the policies implemented?
38. What elements of the PR14 objectives are still relevant for future price reviews?
39. Are there wider considerations that require a change in regulatory approach from PR14?
40. Do you have any other additional information or data that you would like to share with us to assist with the PR14 review?
41. If time allows, would you be happy for us to get in touch to discuss your feedback on PR14 in more detail?

Please provide any evidence and/or examples you may have from your experience of PR14 to support your answers.

**Ofwat (The Water Services Regulation Authority)
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