July 2022

Creating tomorrow, together:
consulting on our methodology for PR24

Appendix 12 – Business plan incentives

Ofwat

1. About this document

This appendix relates to the PR24 Draft Methodology's proposals for business plan incentives (BPIs).

In section 2 we provide detail about how we have assessed and decided upon the proposals presented in Chapter 11 on encouraging quality and ambitious business plans and their anticipated impact.

In section 3 we set out the 'minimum expectations' against which we propose to assess whether companies' PR24 submissions are of sufficient quality in the first part of our business plan incentives assessment. We do not provide additional guidance on the second part of our assessment on business plan ambition in this appendix, for which our proposals are set out in their entirety in Chapter 11 – encouraging quality and ambitious business plans.

2. Our assessment and draft methodology proposals

We have developed our proposals for business plan incentives (BPIs) at PR24 by drawing on our lessons learnt from PR19, PR14 and other regulators' price reviews. In this section we discuss our rationale for key proposals and their anticipated impact.

2.1 The need for BPIs

Our most recent price reviews at PR19 and PR14 provided incentives to encourage companies to submit their best possible business plans. BPIs are also used by other regulators, for example Ofgem at its RIIO-1 and RIIO-2 price reviews.

BPIs improve the resultant outcomes of these price reviews for customers and the environment by encouraging companies to:

- provide the regulator with information on what is achievable over the next five years and beyond.
- identify information that ensures the best possible outcomes are delivered.

Furthermore, during our PR19 lessons learnt exercise companies suggested that business plan incentives encourage their investors, managers and regulation teams to fully engage in our price review process and deliver these outcomes.[1] In our May 2021 consultation document,[2] on our initial views on the framework for PR24, we proposed to continue to use BPIs and stakeholder responses were broadly supportive. We therefore include BPIs in our proposals for the 2024 price review.

2.2 Our assessment framework

This section discusses what we will be assessing within the scope of the PR24 business plan incentives assessment, why and our allocation of rewards and penalties across the parts of our assessment.

[1] Ofwat, 'PR24 and beyond: Our reflections on lessons learnt from PR19', December 2020, p. 92.
[2] Ofwat, 'PR24 and beyond: Creating tomorrow together,' May 2022.

Summary of our proposed assessment

We propose that our PR24 business plan assessment should have two stages. The first stage considers whether submissions are of sufficient quality and covers a broader range of areas than the second stage, which considers the 'ambition' demonstrated. Figure 2.1 below shows these areas, alongside what we did at PR19 for comparison. Figure 2.2 below summarises our proposed approach for determining rewards and penalties based on our assessments of 'quality' and 'ambition'.

Figure 2.1: Proposed scope of PR24 BPI assessment compared to PR19

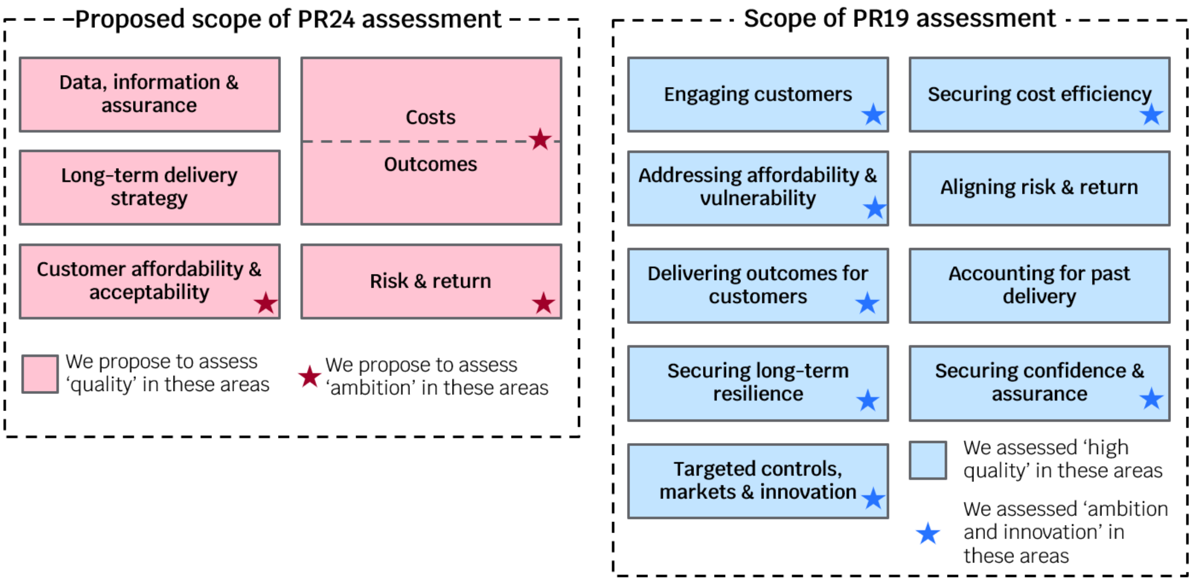
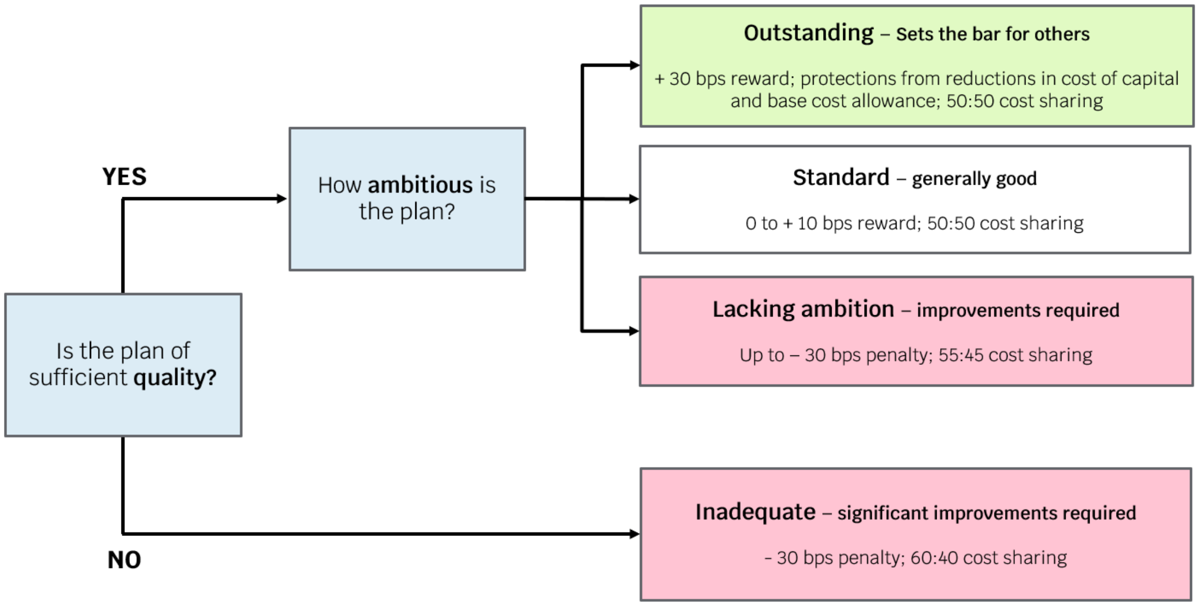


Figure 2.2: Proposed framework for determining business plan rewards and penalties



Quality

Our assessment of whether business plans are of sufficient quality will consider whether they meet a set of minimum expectations in the round. Broadly, our minimum expectations are that plans include the evidence we require; this evidence is sufficient and convincing or, in some cases, compelling; uses our assumptions; and addresses any feedback we have provided.

We propose that companies that do not pass our quality assessment will incur penalties. In section 3 of this appendix we have set out the minimum expectations we propose to test the quality of business plan against so that these are clear when companies prepare their plans. We consider that all companies should be able to meet our minimum expectations in the round and so we do not propose rewards for the quality part of our assessment. Our quality assessment will assess only whether our minimum expectations are met, we describe in the 'Ambition' sub-section the areas in which we will encourage companies to demonstrate ambition using rewards.

Our proposed assessments of quality will focus primarily on areas which are direct inputs to our price control determinations – eg our price control building blocks of costs, outcomes and risk and return – or we consider are necessary to provide us with confidence that our determinations are in the best interests of customers, communities and the environment – eg, that plans are set in the context of a long-term delivery strategy and consider customers' views on affordability. Therefore, we are proposing to reduce the scope of our assessment in comparison to PR19, when we also considered areas such as how companies had demonstrated their resilience[3] and learnt lessons from their past performance (see Figure 2.1).

We consider it is appropriate to target the scope of our assessment at PR24 because:

- **Providing more information** – PR24 will be our third outcomes-based price review, we intend to provide greater information on our expectations of key aspects of our process ahead of business plan submission, eg sharing the results of collaborative customer research and building on our existing base cost models. Therefore, we do not need to encourage companies to provide this information.
- **Simplification sharpens incentives** – we are proposing to simplify the price review process where we consider that ongoing monitoring of companies,

[3] Alongside our other duties, we have a duty to act in the manner we consider best calculated to further the resilience objective. Our PR24 cost allowances will provide sufficient funding for resilience and require companies to maintain and improve asset health performance. Outside of the price review we have commenced work to help us better understand operational resilience and asset health risk.

engagement with relevant stakeholders, and policy development is the most effective policy solution.

We do propose to maintain in our assessment a focus on areas where we consider incentives can make the greatest difference. This includes areas where we need confidence that companies will act in their customers' best interests, for example dividend and performance related executive pay policies and affordability for all customers, including for customers who may struggle to pay their bills.

Ambition

We propose that companies that pass our quality assessment progress to our ambition assessment in which we will consider the extent to which they propose to stretch themselves to deliver more for their customers, communities and the environment during the next price control period, ie the 'ambition' they demonstrate.

Companies that pass our quality assessment and demonstrate sufficient ambition will achieve rewards:

- to encourage them to reveal whether they can deliver better value for their own customers; and.
- because we can use the information they reveal to deliver better value for customers, communities and the environment across the sector.

Consequently, we propose to limit the scope of our PR24 ambition assessment to costs and outcome delivery; customer affordability and acceptability; and risk and return. We can use this information to set more stretching price controls across the sector and encourage companies to include ambitious proposals which will support and enhance overall affordability, including for residential customers who might struggle to pay. It is for companies to explore how, and how much, they can deliver for their customers, communities and the environment in these areas and so the guidance we provide in Chapter 11 on encouraging quality and ambitious business plans is less prescriptive than for our quality assessment.

Companies that demonstrate insufficient ambition will incur a penalty, although the size of this penalty may be smaller than that imposed on companies that fail our quality assessment. We consider that penalties for failing our quality assessment or demonstrating insufficient ambition will provide extra encouragement for companies to engage fully and constructively with the price review process for the benefit of customers, community and the environment. We may – exceptionally – move a company out of the lowest categories but we will ensure that they will be worse off than those companies that provided better plans for their first submission.

Type and value of rewards and penalties

We propose to use a package of financial, procedural and reputational rewards and penalties to encourage companies to provide quality and ambitious business plans (see table 2.1).

Table 2.1 Proposed PR24 business plan incentives compared to those available at PR19 and PR14

	Financial	Procedural	Reputational
PR24	Adjustment equivalent to +/ - 30 bps on regulated equity Cost sharing (50:50–60:40)[4]	Protection from reductions in allowed return and base cost allowances between draft and final determination	'Outstanding'; 'Standard'; 'Lacking ambition' or 'Inadequate' status
PR19	Adjustment equivalent to + 10 - 35 bps on regulated equity Cost sharing (50:50 - 25:75)	We committed not to change our decisions on performance commitments and cost adjustment claims between draft and final determination.	'Enhanced', 'Fast track', 'Slow track' or 'Significant scrutiny' status.
PR14	Adjustment equivalent to + ~ 20 bps on regulated equity	Protection from reductions in allowed return between draft and final determination	'Enhanced' status

[4] We refer to cost sharing rates in the following format (x:y) where 'x' captures the applicable cost sharing rate on overspend incurred by companies compared to PR24 cost allowances and 'y' captures the applicable cost sharing rate on underspend retained by companies compared to PR24 cost allowances.

A range of business plan rewards and penalties

Our proposals for PR24 include multiple types of rewards and penalties. This may superficially appear to be more complex than a single type of reward or penalty, however companies told us during our PR19 lessons learnt exercise and in response to our PR24 high level design consultation that different incentive types have differing appeal to their various stakeholders. We therefore propose that a considered package of incentives will be beneficial to the outcomes of PR24 to maximise company engagement. Its breadth should incentivise a range of company stakeholders.

A stronger package of business plan rewards and penalties

We are proposing to strengthen the overall package of business plan incentives with rewards and penalties in comparison to our 2019 price review. This is in response to feedback during our PR19 lessons learnt exercise that the incentives offered were insufficient to encourage companies to push themselves to provide high quality plans which included sufficient ambition and innovation. [5] This was demonstrated when, for example, companies lacked ambition in their proposed service levels and generally did not reveal innovative ways of working.

We consider that our overall proposed package of business plan rewards and penalties for PR24 is stronger than the package we provided at both the 2019 and 2014 price reviews (see Table 2.1). This is because we propose to:

- **protect companies from reductions** in two material allowances – the allowed return and base costs - while allowing them to benefit from increases, this is in contrast to PR19 when we committed to making no changes to a smaller component of base costs and some performance commitments; and
- **include direct financial penalties** instead of more severe cost sharing rates, therefore creating immediate consequences for poor business plans;

A key consideration when deciding on the total value of rewards is the balance between:

- **increased bills** for customers of qualifying companies; and

[5] Ofwat, 'PR24 and beyond: Our reflections on lessons learnt from PR19', December 2020, p. 92.

- **the benefits that the quality of those companies' business plans deliver** for these customers, and the customers of companies with poorer plans, both now and into the future.

The exact value of proposed business plan rewards at PR24 is dependent on movements in the allowed return and base cost allowance between draft and final determination. However, we estimate it could be worth up to the equivalent of a 55 basis point return on regulated equity. Without these incentives no company might submit an ambitious business plan. The customers of companies that respond to our incentives and do submit ambitious plans receive the benefits of the better outcomes their company proposes. The costs of awarding this to one company would be further offset, and indeed outweighed, by cost reductions by the remaining companies of ~ 3 bps on average, and ~12 bps if three companies were successful. During PR19 most companies accepted reductions in cost allowances alone which greatly exceeded these figures, in addition to agreeing to deliver benefits for customers, communities and the environment such as higher service levels. Consequently, we consider our proposal is highly likely to represent good value for all customers.

Rewards

During our PR19 lessons learnt exercise, we discussed with companies the package of incentives offered.[6] Only one company told us that it made a conscious decision not to go for 'fast track' status because, in its view, the costs outweighed the benefits of the rewards offered. Generally companies highlighted our procedural incentive, which provided certainty that we would not change specified aspects of their determinations, as being less desirable than our commitment at PR14 to protect companies from reductions in the allowed return between draft and final determination but to allow them to benefit from any increases (see Table 2.1). This was demonstrated at PR19 when two out of three qualifying companies opted out of the procedural incentive in part or entirely, whereas at PR14 all qualifying companies accepted the procedural incentive offered.

We have carefully considered the outcomes of our PR19 business plan incentives and companies' feedback. For PR24 we propose to strengthen our procedural incentives by:

- Protecting companies from reductions in the allowed return and base cost allowance while allowing them to benefit from increases, rather than providing them with certainty that there would be no changes.

[6] Ofwat, 'PR24 and beyond: Our reflections on lessons learnt from PR19', December 2020, p. 92.

- Protecting companies from reductions in two material allowances, further increasing the potential value.

We recognise that protecting qualifying companies from changes which would otherwise expose them to adverse risk can act as a strong incentive to provide us with quality and ambitious business plans. We also consider that it can deliver better outcomes for customers and the environment if, after draft determinations, these companies are able to reduce their engagement in the price review process and focus on delivery, while Ofwat can focus on any business plans requiring improvement. At PR24, we therefore propose to protect companies categorised as 'Outstanding' from reductions in the allowed return and base cost allowances between draft and final determination, see Table 2.1.

We also propose to retain direct financial rewards and propose that they should be capped at an equivalent to a + 30 bps return on regulated equity over the entire price control period. This is slightly lower than the maximum financial reward offered at PR19 of + 35 bps. However, as discussed above, we consider the overall potential value of the package of financial and procedural incentives to be greater at PR24 and that stronger procedural incentives should make the package more appealing to a wider range of stakeholders.

Penalties

At PR24, for companies categorised as 'Lacking ambition' or 'Inadequate' we propose to introduce direct financial penalties with a maximum value of – 30 bps (ie symmetrical to the maximum direct financial reward). These financial penalties will be complemented by less favourable cost sharing rates which will apply when companies spend more or less than the efficient cost allowance we include in our final determinations (see table 2.1).[7]

We consider that financial penalties are a stronger business plan incentive than the greater cost sharing rates we applied at PR19 because companies risk incurring guaranteed financial adjustments in year 1 of the 2025–30 price control period when their business plans are of insufficient quality or lack ambition. In contrast, cost sharing rates only impact companies if delivery of their business plan is more or less efficient than our determinations, and financial adjustments are not made until the end of the price control period. Consequently, we consider that this increased certainty and immediacy of the risk of financial adjustments should have greater influence on

[7] We propose a narrower range of rates in comparison to those we used at PR19 (see appendix 9 on Setting expenditure allowances).

companies' business planning than the possibility of reward or penalty at the end of the 2025–30 price control period.

2.3 Application of financial adjustments

We propose that companies can choose to receive financial rewards or incur penalties as an adjustment to their revenue or RCV. Adjustments to revenue or RCV will have the same net present value. We offered companies the same choice for the application of financial rewards at PR19. Two companies took their financial reward as revenue adjustments and the third took most through revenue with the remainder as an adjustment to its RCV.

We propose to continue to offer companies a choice of how we apply financial adjustments, particularly penalties, so that we can provide effective incentives for every company without compromising the financeability of the notional company.

3. Proposed minimum expectations for our quality assessment

We set out in Table 3.1 a summary of the minimum expectations against which we propose to assess companies' business plans for the purposes of determining performance on the 'quality' part of our business plan incentives assessment. The assessments that sit behind these draft methodology proposals are provided in the relevant Chapters and Appendices that are referenced.

We do not provide additional guidance on the second part of our assessment, on business plan 'ambition', in this appendix. For our proposals on the ambition component of the business plan incentives assessment, stakeholders should refer to Chapter 11 – encouraging quality and ambitious business plans.

Table 3.1 Minimum expectations for PR24 business plans

Area	Minimum expectation	References
Data, information and assurance	The submission is accessible and, follows a clear structure, meeting our requirements as specified in our guidance.	Companies' PR24 submissions 10.3
	The company's long-term delivery strategy is fully consistent with the PR24 business plan. Across the PR24 submission, the company presents a single adaptive strategy, rather than multiple alternate plans.	Companies' PR24 submissions 10.4
	The company's full Board provides an assurance statement that meets our Board assurance requirements as specified in our guidance.	Companies' PR24 submissions 10.9
	The company provides the data and information as requested in our methodology and business plan tables. This data and information is consistent, accurate and assured using effective internal systems, controls and processes.	Companies' PR24 submissions 10.9
Long-term delivery strategy	The long-term delivery strategy has been developed in line with our guidance, including presenting future enhancement activities using adaptive pathways and testing against scenarios.	PR24 and beyond: Final guidance on long-term delivery strategies
Customer affordability and acceptability	The company's plan and long-term delivery strategy explain how it has taken account of views on overall affordability including those who struggle, or are at risk of struggling, to pay their bills. The company also explains how it will deliver fairness for both existing and future customers in relation to what they each pay for.	Reflecting an understanding of customers and communities 5.2; PR24 and beyond: Final guidance on long-term delivery strategies
	The company's plan and long-term delivery strategy provides sufficient and convincing evidence that it has used our standardised methodology for testing the affordability and acceptability of its business plan.	Reflecting an understanding of customers and communities 5.3

	The company's submission provides sufficient and convincing evidence that its customer engagement activities meet our standards for research, challenge and assurance.	Reflecting an understanding of customers and communities 5.3
	The company's business plan includes proposals for supporting customers to pay their bills using social tariffs and other methods. We expect the company to include proposals for the two scenarios we specify in our methodology.	Companies' PR24 submissions 10.8
Costs	The business plan sets out the benefits of the company's proposals, specifically: the performance levels delivered through base for all performance commitments; impacts of enhancement expenditure on performance commitments for 2025-30 and the longer term (i.e. to at least 2050); and the additional benefits of its proposals. Wherever appropriate it reflects these benefits in performance commitments and price control deliverables.	Setting expenditure allowances 6.4; 6.5; 6.6
	The business plan and long-term delivery strategy are consistent with the achievement of government targets and statutory requirements. In Wales this includes demonstrating how companies have taken into account the outputs of the collaborative approach.	Setting expenditure allowances 6.5; Companies' PR24 submissions 10.4
	The business plan and long-term delivery strategy include investment options which are consistent with the company's finalised water resources management plan, final WINEP/NEP submission and, if applicable, drainage and wastewater management plan, having adequately addressed any feedback previously provided on these. We also expect compelling evidence on the need for variations from final plans, if relevant.	Setting expenditure allowances 6.5; Design and implementation of price controls 3.3
	The company proposes to use direct procurement for customers (DPC) to deliver eligible schemes.	Design and implementation of price controls 3.9
Outcomes	For common PCs the company's plan contain incentive rates that we propose based on marginal benefit estimates from the collaborative customer research and indicative benefit sharing factors. Where a company provides a different view, it provides compelling evidence, consistent with any relevant guidance.	Delivering outcomes for customers 5.4
	If the company's business plan includes bespoke performance commitments, the company sufficiently demonstrates how it has responded to any feedback we have provided on its definition, or any new proposals meet the expectations we have set out in the methodology. For incentive rates for bespoke performance commitments, the company demonstrates how its proposals are consistent with our draft methodology and any relevant guidance.	Delivering outcomes for customers 5.2
Risk and return	The business plan uses our early view of the allowed return on capital or provides compelling evidence that another rate is more appropriate.	Aligning risk and return 7.3
	The company's submission provides sufficient and convincing evidence that the overall business plan provides an appropriate balance of risk and return.	Aligning risk and return 7.2
	If the company's business plan includes bespoke uncertainty mechanisms and notified items then these meet the expectations we have set out in our methodology.	Aligning risk and return 7.2

	The company's Board provides assurance that its business plan is financeable on the basis of the notional structure and this is supported by sufficient and convincing evidence of the steps taken to provide this assurance.	Financeability 8.1; 8.4; 8.5
	The business plan uses appropriate cost recovery rates and provides sufficient and convincing evidence for any adjustments to underlying PAYG and RCV run-off rates.	Financeability 8.2
	The company's Board has provided assurance that it will maintain financial resilience during 2025-30 and in the long-term, taking account of its business plan under its financing and capital structure. We expect also this is supported by sufficient and convincing evidence of the steps taken to provide this assurance and of the steps to improve financial resilience where necessary.	Promoting financial resilience 9.2; 9.3
	The business plan sets out the company's dividend policy for 2025-30 and the policy is in line with our guidance.	Promoting financial resilience 9.5
	The business plan sets out the company's policy for performance related executive pay during 2025-30 and the policy is in line with our guidance and Board leadership, transparency and governance principles.	Promoting financial resilience 9.6

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales.

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