July 2022

Creating tomorrow, together

Consulting on our methodology for PR24

Ofwat

Creating tomorrow, together

Water is central to our existence. How the water sector performs now and into the future matters for all of us and our environment.

We've listened to people's concerns and ambitions for the water sector. We understand the urgency of the environment and climate change challenges, and that customers need reliable and resilient services. We're also conscious of the pressure on people's finances, and the need to find new and innovative ways of delivering now and into the future.

We have set out our proposals to drive companies to deliver value for customers and the environment, and to meet four key ambitions for PR24:

Focusing on the long term with stronger adaptive planning to deliver the right investment to meet immediate and long-term challenges when the future is uncertain, as well as holding companies to account for the improvements that they need to deliver

Delivering greater environmental and social value, including by acting immediately on river water quality, moving faster towards net zero, and working differently to deliver more catchment- and nature-based solutions.

Reflecting a clearer understanding of customers and communities with open meetings on companies' plans, more robust research to ensure customers' voices are heard and better understood, and wider engagement with partners.

Driving improvements through efficiency and innovation innovation and rewarding companies that produce the most ambitious business plans to meet the challenges facing the sector.

We welcome feedback from all stakeholders by 7 September 2022. We will take account of these views, and we will finalise the methodology for PR24 in December 2022.

What happens in a price review

Companies

work with their **customers and communities** to develop a five-year business plan, set in the context of a long-term delivery strategy which looks at the next 25 years. Companies' plans must deliver their legal obligations, including for drinking water quality, and the environmental improvements set by the **Environment Agency** and **Natural Resources Wales**.

Ofwat sets the framework for the review, in line with priorities set by the **UK and Welsh Governments**. We scrutinise and challenge companies' plans and we set the price, service and incentive package for the next five years. We encourage companies to set new standards of what can be achieved, and push the whole sector forward to deliver great outcomes at prices customers can afford. We then monitor performance and hold the companies to account for the outcomes they deliver.

Customers

fund each company to be prepared for the future and to deliver key outcomes. These include core services for customers and their obligations to improve the environment and tackle climate change.

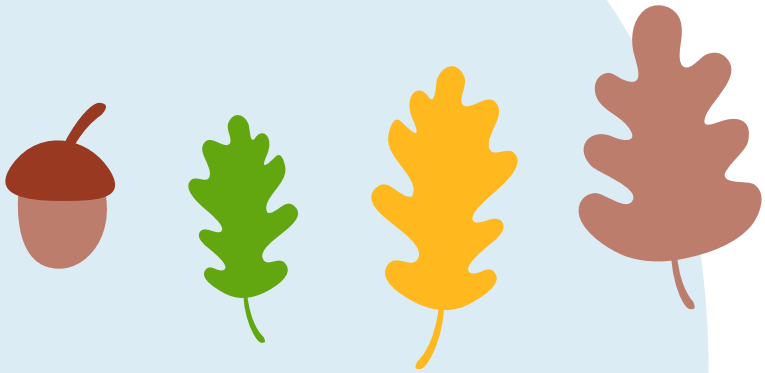
Focusing on the long term

Tackling climate change, cleaning up our rivers, securing our future water supplies and enhancing biodiversity are all challenges that require action now to deliver the environment we all want for future generations. Companies will set their business plans for 2025-30 in the context of clear delivery strategies for the next 25 years. These strategies will focus on the long-term improvements needed, in line with the priorities set for Ofwat by the UK and Welsh Governments.

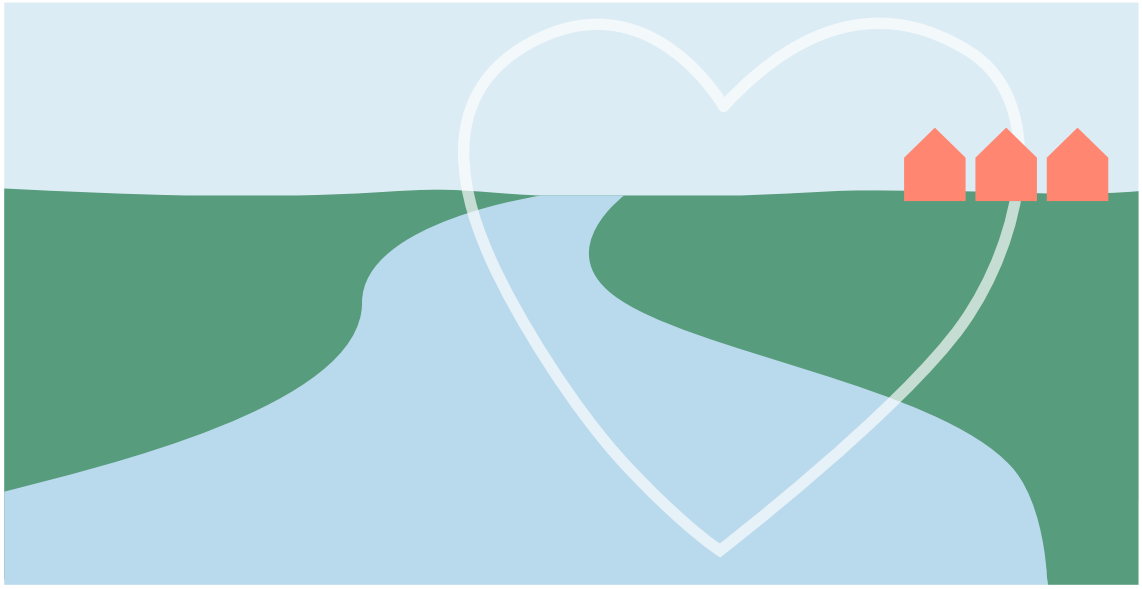
Our approach in the price review will mean that customers' money can be spent well to deliver what is needed over the long term. Funding will support adaptive planning by companies – supporting work for investment that is needed now, as well as keeping options open for the future when better information might reveal the best value solution. Avoiding costly approaches that turn out not to be needed means that more money can be spent on solutions that will deliver tangible benefits.

Price controls already provide a great deal of long-term certainty for water companies, particularly when compared to unregulated sectors. We are building on this in PR24. We are focusing on the outcomes that matter most to customers, and we're going to keep focusing on these into the future. We'll use financial incentives to align the interests of companies and investors with what's best for customers, communities and the environment. And we will continue to hold companies to account, and reward great performance into the future, by ensuring that future price reviews reflect what companies have promised at PR24.

Our approach will allow companies to invest now in improvements that will benefit future generations. And we'll ensure that the costs of these improvements are shared fairly between current and future customers. We propose to steer companies more strongly to ensure that the costs recovered in 2025-30 reflect a reasonable balance between current and future customers. And we will use incentives on business plans to reiterate our expectations that companies' dividends and approach to executives' performance-related pay should reflect how well they deliver for customers, communities and the environment.



Delivering greater environmental and social value



Water companies are key long-term members of their local communities. They provide essential services to people and organisations in their areas, and they can have a profound impact on the environment.

This price review will push companies to do better across a range of key issues, particularly on the environment. We will incentivise company performance on biodiversity, carbon emissions, water use, storm overflows and impacts on rivers and bathing water. Our approach in PR24 will provide greater certainty about the funding for nature-based solutions and other alternatives to traditional, capital investment heavy, choices. Companies need to step up, be ambitious, and deliver affordable, best value solutions.

We want to see companies making rapid progress on the operation of storm overflows. In advance of PR24, several companies have responded to our calls for improvements in river quality and storm overflows. We expect all companies to at least match the most ambitious commitments offered and to improve performance by 2025. PR24 will then drive further improvements from this higher standard.

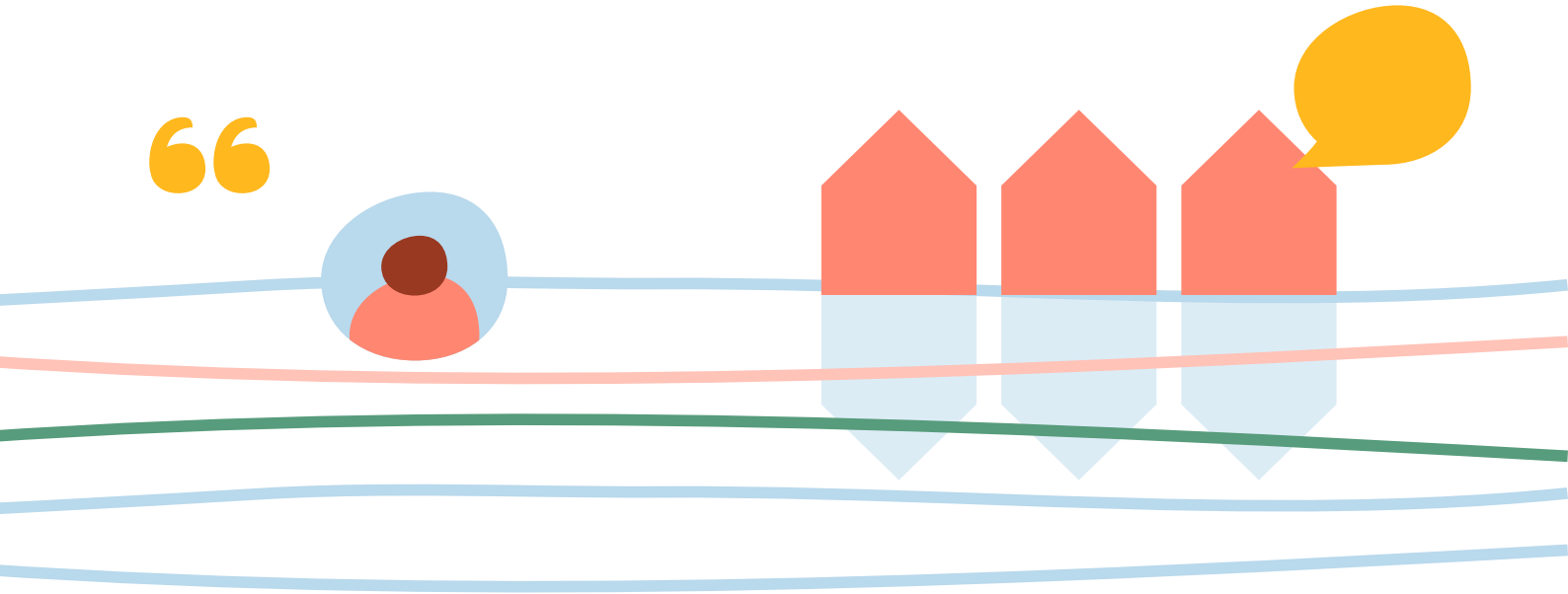
We are also challenging companies to identify the most impactful, best value solutions towards net zero. We propose to make additional funding available to the most efficient companies, to allow them to go further, faster, to reduce emissions. And overall, the environment and all customers will feel the benefits more quickly as these innovative solutions will then set the standard for the whole sector to adopt.

Reflecting a clearer understanding of customers and communities

Business plans need to reflect the expectations of customers and communities for the services and benefits the company will deliver, and the cost of those services. Our ambition is that residential and business customers' voices are heard more directly and more effectively in PR24 than ever before. Closer, more transparent engagement will also be vital to address urgent challenges such as driving down water demand, which require much more effective partnerships with customers and communities.

Working with the companies and CCW (the voice of the water consumer), we've developed targeted cross-sector research to reveal customers' relative priorities and views on the outcomes that companies need to deliver. Having robust and comparable company-by-company information about customers' views will help us to make decisions that better reflect the needs of customers and communities.

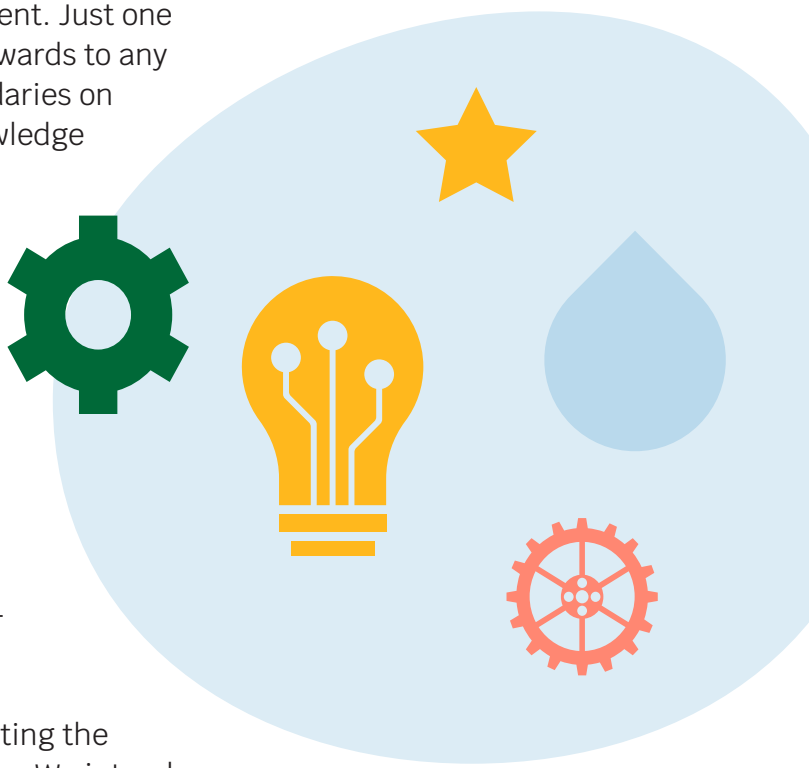
We will also ensure that customers and other stakeholders can comment directly on companies' plans. We plan to introduce open challenge sessions which will give customers and stakeholders a chance to share concerns and ask companies questions. Companies will need to demonstrate that their plans are affordable, including for those struggling to pay. And reflecting the specific circumstances and ways of working in Wales we are taking forward a new collaborative approach. We are engaged in the new Wales PR24 Forum that will enable Welsh stakeholders to identify key high-level outcomes and priorities for the sector in Wales.



Driving improvements through efficiency and innovation

Companies need to innovate constantly to achieve the best outcomes for customers, communities and the environment at a cost that people can afford. PR24 will ensure that customers do not pay more than they need to, and reward only those companies that are ambitious and deliver great outcomes.

We will do this by setting stretching but achievable performance standards for the whole sector. And we will encourage companies to go further through simple and powerful incentives to deliver better performance where it is in the interests of customers, communities and the environment. Just one example is a new approach to offer greater rewards to any company that exceptionally pushes the boundaries on performance, provided that it shares the knowledge gained with the rest of the sector.



At PR24 we will continue to expect companies to work in different ways to achieve more. We will incentivise companies to work in partnership with others where appropriate to identify better, more holistic and sustainable solutions. We propose to continue using development funding to drive more progress on the delivery of strategic water resource solutions. And we intend to extend our Innovation Fund to support sector-changing ideas and ways of working.

We will use markets where appropriate, reflecting the UK and Welsh Governments' strategic priorities. We intend to make more use of direct procurement for customers for large infrastructure projects to deliver more efficient financing costs, and we will incentivise companies to manage the process well. PR24 will also introduce more scope for innovation in developer services and bioresources to deliver more for customers.

And we are proposing to conduct the price review process differently. In addition to streamlining our approach to outcomes and business plan incentives, we are cutting the determination stage from three phases to two. We expect companies to provide quality and ambitious information up front in their business plans. We will penalise those that fall short, as well as rewarding those that show the most ambition. Overall, we expect these changes to allow everyone to focus more on what really matters to deliver better outcomes for customers, communities and the environment.

Responding to this consultation

We would welcome any comments on this document. Please email them to PR24@Ofwat.gov.uk or post them to:

PR24 draft methodology consultation response
Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

The closing date for this consultation is 5pm 7 September 2022.

We intend to publish responses to this consultation on our website at www.ofwat.gov.uk. Subject to the following, by providing a response to this consultation you are deemed to consent to its publication.

If you think that any of the information in your response should not be disclosed (for example, because you consider it to be commercially sensitive), an automatic or generalised confidentiality disclaimer will not, of itself, be regarded as sufficient. You should identify specific information and explain in each case why it should not be disclosed (and provide a redacted version of your response), which we will consider when deciding what information to publish. At a minimum, we would expect to publish the name of all organisations that provide a written response, even where there are legitimate reasons why the contents of those written responses remain confidential.

In relation to personal data, you have the right to object to our publication of the personal information that you disclose to us in submitting your response (for example, your name or contact details). If you do not want us to publish specific personal information that would enable you to be identified, our privacy policy explains the basis on which you can object to its processing and provides further information on how we process personal data.

In addition to our ability to disclose information pursuant to the Water Industry Act 1991, information provided in response to this consultation, including personal data, may be published or disclosed in accordance with legislation on access to information – primarily the Freedom of Information Act 2000 (FoIA), the Environmental Information Regulations 2004 (EIR) and applicable data protection laws.

Please be aware that, under the FoIA and the EIR, there are statutory Codes of Practice which deal, among other things, with obligations of confidence. If we receive a request for disclosure of information which you have asked us not to disclose, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances.

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This version of the document was published on 22 July 2022 to incorporate updated versions of figure 1.1 and figure 3.1.

This version of the document was published on 4 August 2022 to incorporate an updated version of figure 1.1 and question 5.1.

1. Introduction

We are consulting on our draft methodology for the 2024 price review (PR24), which we will use to set controls for the period from 2025 to 2030. This document sets out our proposed approach and expectations of companies. We are seeking views on these proposals from stakeholders. This will help us refine our methodology, which we will publish in December 2022.

1.1 Background

The consultation follows on from our:

- consultation in May 2021 about the high-level design of PR24[1]
- subsequent series of position and discussion papers that expand our thinking[2]
- ongoing engagement with stakeholders, including companies, on different elements of the price review, including ideas about its evolution through the Future Ideas Lab.[3]

1.2 Our consultation

This document contains a series of chapters, which are listed on the table of contents. In addition, there are a number of separate documents that support our proposals. They include:

- Appendices, which provide further detail and our reasoning for our proposals
    - Appendix 1 - Affordability
    - Appendix 2 – Water trading incentive
    - Appendix 3 – Developer services
    - Appendix 4 – Bioresources control
    - Appendix 5 – Direct procurement for customers
    - Appendix 6 – Performance commitments
    - Appendix 7 – Performance commitment definitions
    - Appendix 8 – Outcome delivery incentives
    - Appendix 9 – Setting expenditure allowances
    - Appendix 10 – Aligning risk and return
    - Appendix 11 – Allowed return on capital
    - Appendix 12 – Business plan incentives
    - Appendix 13 – Data and modelling

[1] Ofwat, 'PR24 and beyond: Creating tomorrow, together,' May 2021.
[2] Ofwat, 'PR24 useful documents.'
[3] Ofwat, 'PR24 working groups and workshops' , 2022, and Ofwat, 'Future Ideas lab', 2022.

- How we are delivering UK and Welsh governments' priorities for the English and Welsh water sectors through PR24.
- Data tables (plus submission table guidance files), financial model (plus Openbox format file and user guide), and model suite diagram.
- Independent consultancy reports
  - Incentivising Net Zero – a report for Ofwat (Frontier Economics, April 2022)
  - Methodologies for measuring outcome delivery incentive risk – a report for Ofwat (PwC, July 2022)
- PR24 draft methodology glossary

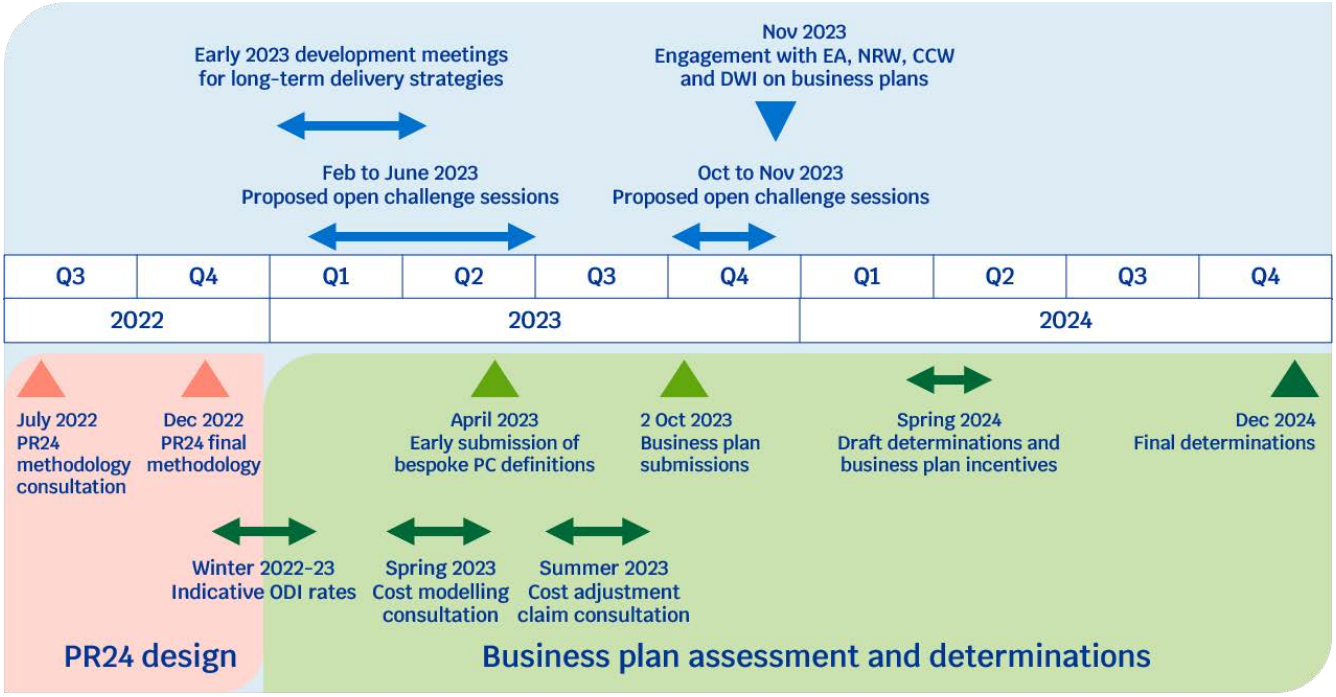
PR24 draft methodology response template

1.3 Next steps

We would welcome responses to this document by 5pm on 7 September 2022. We want to hear views on the proposals set out in this document from across the sector, including water companies (both regional and new entrant), business retailers, Market Operator Services Ltd. (MOSL), companies in the wider supply chain, as well as public bodies, other regulators, customers and their representative groups and environmental organisations. We will consider your responses when we finalise the methodology for PR24.

The next steps in the PR24 process after final methodology are illustrated in Figure 1.1 overleaf.

Figure 1.1: PR24 timeline



2. Regulating through the price review

2.1 Introduction and summary

In this chapter, we set out the key challenges facing the sector and our ambitions for the PR24 price review (PR24). We explain how the 'building blocks' of the price review – the outcomes regime, our cost assessment process, and our risk and return framework – create value. And we set out the wider context, including how we use tools outside of the price review. We also explain how we will evaluate PR24's impact on customers, society and the environment.

The chapter covers:

- key challenges and our ambitions for PR24 (section 2.2);
- how price reviews, and specifically PR24, can meet the challenges (section 2.3);
- how we also use tools beyond the price review, including markets, where they are the most effective (section 2.4); and
- how we will evaluate the impact of PR24 (section 2.5).

2.1.1 Key messages

We have set out four ambitions for PR24 to help address the key challenges facing the sector. These ambitions are:

1. increasing **focus on the long term**;

2. delivering **greater environmental and social value**;

3. reflecting a **clearer understanding of customers and communities**; and

4. driving improvements through **efficiency and innovation**.

We will be meeting these PR24 ambitions through the building blocks of the price review as well as long-term delivery strategies, business plan incentives and innovation. All of these areas, alongside our wider toolkit, will support better outcomes for customers, communities and the environment, including affordability.

2.2 Key challenges and our ambitions for PR24

How the water sector performs now and into the future matters for all of us and our environment. Despite improvements, the water sector is not where it needs to be. The challenges before us are clear and urgent:

- combatting **climate change** as well protecting and enhancing our **environment**, including the sustainable management of **natural resources**;
- rising **customer expectations** about what companies need to deliver for their customers and communities, including protecting and enhancing the environment; and
- the need for **affordable bills**.

To address the challenges facing the sector, we have identified four inter-related ambitions for PR24:

- increasing **focus on the long term**;
- delivering **greater environmental and social value**;
- reflecting a **clearer understanding of customers and communities**; and
- driving improvements through **efficiency and innovation**.

These ambitions were supported by stakeholders in responses to our May 2021 publication. **Figure 2.1** shows key challenges and our ambitions for PR24.

Figure 2.1: Key challenges and ambitions for PR24

2.2.1 Our statutory duties and the strategic policy statements

The ambitions take account of our statutory duties. Our statutory duties require us to set price controls in the manner we consider is best calculated to:

- **further the consumer objective** to protect the interests of existing and future consumers, wherever appropriate by promoting effective competition;
- secure that water companies **properly carry out their functions**;
- secure that the companies **are able (in particular, by securing reasonable returns on their capital) to finance the proper carrying out of those functions**; and
- **further the resilience objective** to secure the long-term resilience of companies' systems and to secure that they take steps to enable them, in the long term, to meet the need for water supplies and wastewater services.[4]

We also have secondary duties that require us to regulate in the way we consider will best promote economy and efficiency as well as contribute to the achievement of sustainable development. In addition, we must have regard to the principles of best regulatory practice, including that our regulatory activities should be transparent, accountable, proportionate, consistent and targeted.

We must also act in accordance with the strategic policy statements (SPSs) from the UK government and the Welsh Government when setting price controls.[5] The draft methodology reflects our statutory duties and the strategic priorities and objectives from the UK government and the Welsh Government that will apply to us when we set price controls at PR24.

The priorities the UK government has set us for how we regulate English water companies are to protect and enhance the environment (including water quality), deliver a resilient water sector, serve and protect customers, and use markets to deliver for customers. The UK government has also outlined strategic priorities for utilities sectors in an open letter to regulators, which complement the UK government's SPS priorities.[6]

We have been working closely with the Welsh Government over the last 12 months on a new Welsh SPS, which was being finalised as we were finalising this draft methodology. We have sought to reflect the new SPS's high level strategic objectives and priorities when developing the draft methodology. The new SPS includes a focus on outcomes, the long term, best value, collaboration, and customers and communities as well as on responding to the climate and

[4] The general statutory duties for most of our work as an economic regulator that we summarise here are set out in section 2 of the Water Industry Act 1991. We also have general environmental and recreational duties set out in section 3 of that Act.

[5] Defra, 'The government's strategic priorities for Ofwat', February 2022 and the Welsh Government, 'Strategic objectives and priorities for Ofwat', laid before the Senedd 6 July.

[6] Letter from the Secretary of State for Business, Energy and Industrial Strategy to the economic regulators, 'Strategic priorities and cross-sectoral opportunities for the utilities sectors: open letter to regulators', January 2022.

nature emergencies, driving environmental improvements, resilience, and asset health. When we finalise the PR24 methodology, it is likely that the new SPS will have replaced the current SPS. We will ensure that the final methodology reflects the final new SPS, and we will continue to work closely with Welsh Government in this area.

2.2.2 Our toolkit for meeting the challenges

We will use a wide range of tools to meet the challenges, some of which will be inside the price review (discussed in Section 2.3) while others will be outside it (discussed in Section 2.4). Our choice of tools is determined by their effectiveness. As we highlighted in our May 2021 publication, some areas of our responsibilities are better addressed outside of the constrained timetable of a price review.

A key area requiring our full toolkit is **affordability**. We propose to use PR24 as a key tool for regulating companies to deliver overall affordability, value for money, and affordability for current and future customers. However, we propose that our wider tools outside of PR24 are more effective for many issues, such as our charging rules and guidelines on debt management, and collaborating with others such as CCW to support customers struggling to pay their bills. How we approach affordability is discussed in Section 2.4.3 and Appendix 1.

2.3 PR24 toolkit

To meet the challenges described above, we will be maintaining the building blocks approach for PR24 of outcomes, costs, and risk and return. We will also be drawing on additional tools that encourage companies to further plan for the long-term, deliver high quality and ambitious business plans as well as to innovate. In the rest of this section, we give an overview of how we will use these tools in PR24. We want companies to deliver the best outcomes possible at a price that customers can afford, now and into the future.

2.3.1 Delivering the right outcomes

For the sector to succeed, it is vital that companies deliver the right outcomes for their customers, society and the environment. We do this through our outcomes framework, which holds water companies to account for the outcomes that customers pay for and incentivises them to go further where it will deliver value. It has also been supported by stakeholders' responses.

We are creating simpler and stronger incentives for outcomes through streamlining our approach. We are doing this by focusing on the key outcomes. These are likely to be important in future price reviews as well as PR24. We propose that most outcomes are measured in the same way for different companies through common performance

commitments. We propose several new measures relating to improved outcomes for the environment, including river water quality. And we propose a new common performance commitment for the English water companies (BR-MeX) to improve company performance in relation to the wholesale services they provide to retailers and business customers.

There may be a small number of bespoke performance commitment measures for individual companies where necessary to address an issue of specific local importance. Overall, we expect to there to be around half the number of the performance commitments there were at the last price review, PR19.

We are proposing to incentivise outcomes through outcome delivery incentives (ODI) rates. using the results of collaborative customer research. This should strongly incentivise improved outcomes for customers and the environment. We propose to extend enhanced incentives for very high performance on well-established performance commitments to all companies to encourage **innovation**. We expect the revenue at risk from ODIs will remain one to three per cent return on regulatory equity each year. To limit the overall level of risk to customers and companies, we are proposing an aggregate sharing mechanism that shares payments between customers and companies if total incentive payments reach certain thresholds. We propose to use caps and collars on individual performance commitments on a targeted basis, for example, on new performance commitment measures.

2.3.2 Assessing efficient expenditure

The proposals in our draft methodology help drive companies to produce business plans that are affordable to customers. This is supported by our scrutiny of plans. Our scrutiny supports **affordability** by ensuring customers:

- pay an efficient cost for their water and wastewater services, including for meeting challenges such as climate change; and
- do not pay again for what should have been done earlier.

At PR24, we are building on our established approach to cost assessment to drive greater:

- efficiency and innovation;
- focus on the long-term; and
- delivery of obligations and best value approaches, including nature-based solutions and those that deliver better carbon and biodiversity outcomes.

We aim to drive **greater efficiency and innovation** by expecting stretching but achievable performance improvements from base expenditure. And companies will also be incentivised to be more efficient and innovative over time by allowing them a share of any underspend if they beat our cost allowances and ensuring they also bear a share of any overspend. We use the most efficient companies to set benchmarks for what other companies can achieve by

using "comparative" competition. We do so through econometric models, which we propose greater use of in PR24 to benchmark companies' efficient base costs (ie the routine, year-on-year costs to deliver good service). We also intend to set price controls that reflect companies' efficient costs for the long-term maintenance and renewal of their networks and growth in the size, density and complexity of the network.

Companies need to deliver resilient services over the long term, and we ensure they have funding to do this efficiently. Our expectation is that historical allowances have been sufficient for companies to maintain and improve outcomes and asset health metrics. However, we are adjusting our approach to take better account of forward pressures and will adjust allowances where increasing risks require additional funding.

We will facilitate efficient investment over 2025-30 and the long-term. Companies need to do more to meet the challenges over the long term and we expect them to make use of adaptive planning. We will facilitate long-term investment through greater clarity on the treatment of multi-period investments and outcomes. On protecting the environment and enhancing our natural resources, including net zero and storm overflows, we will incentivise companies to go faster where it is efficient and appropriate for them to do so. We will incentivise companies to find the best and most efficient solutions, which will help the whole sector deliver.

We expect companies to deliver long-term best value. This will require companies to take account of wider environmental and social benefits, costs, risks and affordability of customers' bills when developing their enhancement proposals. We will provide better certainty of funding for nature-based solutions over the long term at PR24. We will reward companies that work in collaboration with other parties so that the delivery of wider benefits does not have to cost more to customers.

2.3.3 Aligning risk and return

Our aim for PR24 remains to align the interests of companies and investors with those of customers, so that the sector is attractive to investors, but companies can only earn high returns from great performance. The return on capital makes up an important part of customer bills; our approach will ensure that investors receive a reasonable return on their capital but which will not leave customers bearing unnecessarily high bills in PR24 and beyond.

We retain the use of PAYG and RCV run-off as the mechanisms for companies to recover their costs from customers over time. We will consider how the PAYG and RCV run-off cost recovery rates proposed by companies reflect the levels of proposed expenditure. For PR24 we propose to set a narrow range for RCV-run off rates, informed by a consideration of the remaining asset lives, that represents a reasonable balance of cost recovery between current and future

customers. We propose to set out this guidance in our final methodology and we expect companies to take account of the guidance in their business plans.

We also want to incentivise less capital-intensive solutions, where they are the best value approach. We are supportive of an option put forward by companies that would allow nature-based solutions that are mainly on-going operating expenditure to be treated as investments that can be added to the RCV, subject to addressing the challenge to deliver a workable solution.

We intend to retain our approach in which returns are determined by an allowed base return on capital, as well as a framework of incentive and risk allocation mechanisms. We propose to set a fixed allowance for the base return on equity using the capital asset pricing model (CAPM) and appropriate cross-checks. We also propose to set a cost of debt allowance based on a component for embedded debt using a benchmark for companies' balance sheet debt costs, and an indexed component for new debt using a benchmark index. We expect that at PR24 the cost of debt will be materially lower than at PR19.

We consider there may be a case for a stronger role for equity in the notional capital structure. We will need to be confident that equity buffers are sufficient as the sector adapts to a more uncertain future, for example driven by **climate change,** and other sources of uncertainty, and to ensure for effective operation of the incentive-based regime. We may therefore set a lower level of notional gearing at PR24 compared to PR19. We are also **simplifying** our approach by transitioning to just one inflation index for the Regulatory Capital Value. This removes the link to RPI which is no longer considered a good measure of inflation.[7] We will also operate a proportionate suite of uncertainty mechanisms.

We expect companies to submit business plans that are **financeable**, such that an efficient company with the notional capital structure can finance its investment on reasonable terms both now and in the long term. We expect this to be supported by board assurance and we expect companies to assess and report on risks around their business plan.

Companies and their boards remain responsible for maintaining long-term financial resilience on an actual basis within the context of their price determination, the licence and company law. We intend to retain the requirement for companies' boards to provide assurance and demonstrate that business plans are set in the context of allowing financial resilience to be maintained in 2025 to 2030 and beyond. Companies should explain the steps they are taking to secure financial resilience where risks are identified.

We consider more needs to be done to strengthen the regulatory protections from risky financial structures and we will set out our proposals under a separate consultation to be published over the summer. We consider these protections are best achieved through strengthened ring-fencing provisions in the licence and through regular monitoring of companies and we will consult separately on these issues. However, we may apply an

[7] Office for National Statistics, 'Shortcomings of the Retail Prices Index as a measure of inflation,' March 2018.

incentive-based mechanism within the price review if we are not satisfied with progress achieved through other means. We will return to this in the final methodology taking account of responses to our separate consultation.

2.3.4 Long-term delivery strategies

The water sector in England and Wales is long term in nature and faces a series of long-term challenges. Our PR24 regulatory framework utilises the 'building blocks' approach developed in PR14 and PR19, and begins to look forward to PR29 and beyond.

We are addressing long-term challenges in PR24 by asking companies to produce long-term delivery strategies, and by setting out parts of the framework for PR29 and beyond, to improve decision making in the short term in the context of long-term objectives.

This means we want companies to set out their five-year business plan in the context of a 25-year delivery strategy to address long-term challenges. Adaptive planning should be at the heart of a long-term delivery strategy to establish what enhancement activities are needed now and key decision points in the future when there is likely to be more certainty about what is needed. The planning will need to take account of customer views and affordability concerns. It will help companies ensure their plans are joined up across all their activities and that they have thought holistically how the future may be different from now.

We propose to set performance commitment levels that are, where possible, common across companies. Companies should deliver stretching outcomes from base funding and their enhancement expenditure should be in line with a robust long-term strategy. This will help to deliver long-term value for customers, communities and the environment. We will hold companies to account into the future by setting performance commitment levels in future price control periods with reference to what they should have already achieved.

2.3.5 Encouraging high-quality and ambitious business plans

Getting high-quality business plans that are ambitious helps us drive the best outcomes for customers and the environment overall. We also want to encourage companies to get the information to us that meets our expectations as quickly as possible. We use business plan incentives to do this. Ambitious plans help us to set stretching price controls for the sector.[8] We propose to use a range of reputational, financial and procedural incentives at PR24 to encourage companies to do this.

We will assess plans on the extent of their:

- quality; and

[8] See Section 11.2.

- ambition.

Where a company's plan has high levels of quality and ambition, it will be rewarded. Where a company does not demonstrate enough quality, or lacks ambition, it will receive a penalty.

Our assessment will include whether the water companies have listened to a broad range of voices. We propose several new approaches that will strengthen stakeholders' roles in the process, including:

- better clarity of customers' priorities through more robust customer research
- the collaborative approach in Wales, through the Wales PR24 Forum;
- open sessions for stakeholders to challenge companies; and
- closer working with our fellow regulators and CCW.

This helps us get further information and scrutinise business plans more effectively from a broader perspective.

2.3.6 Innovation fund

We have a variety of mechanisms within the price review for incentivising innovation, including enhanced incentives and the cost sharing mechanism. In addition to these mechanisms, we established a £200m innovation fund at PR19, which is funded through the price review. The aim of this funding is to spur innovation in:[9]

- responding and adapting to climate change;
- restoring and improving water environments;
- understanding and mitigating long-term operational resilience and infrastructure risks;
- testing new ways of conducting core activities; and
- the use of open data.

The innovation fund is funded through the price review but is delivered independently from the price review process over the whole of the five-year period. The design of the fund and individual competitions has and will continue to be adapted based on insights and learning developed during delivery to ensure we are meeting our stated aims. Subject to ongoing evaluation, we expect to confirm that the fund will continue at PR24.[10]

[9] The strategic innovation themes are available on our innovation funding competition here.
[10] We are also working together with the Environment Agency and the Drinking Water Inspectorate to provide a single point of contact for regulatory advice for innovators and businesses in England and Wales. The new service - StreamLine - aims to support businesses in England and identify perceived and real regulatory barriers to innovation.

2.4 Our wider tools to meet the key challenges

We have a wide range of tools in addition to price reviews available to us to help drive the sector to meet its challenges. They include markets, licensing and enforcement, assurance and monitoring as well as campaigns and partnerships. We choose our most effective tool to meet specific objectives. And together, they help us to encourage companies to deliver the best outcomes for customers, society and the environment.

2.4.1 Markets

We use markets where they help provide good outcomes for customers, society and the environment at a reasonable cost. We have opened several parts of the water sector to competition so far. At PR24, we expect certain large infrastructure projects to be delivered through Direct Procurement for Customers (DPC).

We use markets to improve **environmental outcomes**. For example, in the bioresource market, companies have responded to market demands and regulatory incentives and used anaerobic digestion to produce green energy for the market. Competitive pressures can improve **efficiency**, which in turn helps with **affordability**.

Competition in the developer services market has grown in recent years, in which incumbent water companies compete with other companies to provide developers with connection services. These new providers can provide faster, more responsive services and lower prices than incumbent water companies. They can also potentially provide developer services across utilities, reducing coordination issues.[11]

2.4.2 Monitoring and enforcement

We **monitor companies and hold them to account for their performance**. We will consider the use of enforcement action wherever a company's performance falls significantly short and breaches relevant legal obligations.[12] We have taken enforcement action in recent years on a range of environmental issues, including six current enforcement cases into whether companies' wastewater treatment works are consistent with their environmental permits.[13]

[11] Ofwat, 'Review of incumbent company support for effective markets', August 2020.
[12] We presently have an investigation into all water and wastewater companies in England and Wales about how they manage their wastewater treatment works to meet their environmental permits. This currently includes live enforcement cases against six companies. Ofwat, 'PN 10/22: Five water companies targeted in next phase of Ofwat wastewater treatment work investigation', March 2022; Ofwat, 'PN 24/22: South West Water latest company targeted in Ofwat investigation due to environmental performance,' June 2022.
[13] Ofwat, 'PN 10/22: Five water companies targeted in next phase of Ofwat wastewater treatment work investigation', March 2022; Ofwat, 'PN 24/22: South West Water latest company targeted in Ofwat investigation due to environmental performance,' June 2022.

2.4.3 Affordability

Affordability is a policy area for which we draw on our toolkit both inside and outside of the price control. While we propose that PR24 is our primary tool for regulating companies to deliver overall affordability, we also use our wider toolkit outside of PR24, particularly to support customers struggling to pay their bills.

We hold companies to account through their licences, our determination powers, charging rules and wider powers. In May we published new guidelines for water companies to **help customers pay bills, get help and repay debt**.[14] And we have started work with the sector to provide a clear regulatory basis for the requirement for companies to **treat customers fairly**. We are consulting in the autumn on whether our charging rules and companies' charges could do more to support the **affordability of water bills**.

We use campaigns and collaboration with industry and stakeholders to respond more flexibly to changing circumstances. Our listen, care, share campaign examined the many pressures that water customers struggled under during the pandemic, including financial difficulties and physical and mental health problems. We also released research in May 2022 that highlighted water customer experiences in relation to **cost of living.**[15]

We collaborate with other agencies and industry to achieve better outcomes. We have supported CCW in its affordability review, and are working with government and the sector on introducing a **single water affordability discount scheme**, the single social tariff.

2.5 How we will evaluate the impact of this price review

This draft methodology sets out our views on the best ways to achieve the ambitions we have set out.[16] We assess the impacts of our policy proposals in the appendices to the draft methodology. Our approach to assessing these proposals is tailored to the policy areas, for example, depending on their materiality and the extent of change. We intend to publish a summary of our assessment of the impacts of our key proposals for PR24 alongside our final methodology, taking account of stakeholder comments on this document.

Ofwat is committed to evaluating the impact of our regulatory activities after they have been implemented, to help us and stakeholders understand the extent to which our goals have been achieved. For example, the importance of learning from experience is included in the

[14] Ofwat, 'Paying fair – guidelines for water companies in supporting residential customers pay their bill, access help and repay debts,' May 2022.
[15] Ofwat, 'Cost of living: water customers' experiences,' May 2022.
[16] We have considered the impact of our proposals and compared them with alternative options, including on protected groups where relevant. The appendices of the relevant chapters cover this and explain why we think our proposals are the best option. The impacts are considered integrally to our proposals and relative to other options we have considered which include, where relevant, our PR19 approach and other alternatives put forward by stakeholders and further options we have considered. In line with our guidance, we have not produced a separate standalone impact assessment as we consider it integral to forming our policy.

Terms of Reference for the PR24 Forum in Wales. This helps us learn about the effectiveness of our regulatory interventions to inform future policy decisions and demonstrate our accountability to customers, to society, to stakeholders and to Parliament.

Our approach to the ex-post evaluation of this price review will be based around the four ambitions set out in Section 2.1.1. In addition to carrying out an overall assessment of PR24, we will carry out several strands of evaluation including a lessons-learned exercise for the PR24 process and policy-specific evaluations where appropriate.

Stakeholders were generally supportive of reviewing price reviews, and favoured tracking overall delivery for customers through price control outcomes and outputs using a long-term perspective. Some stakeholders suggested that evaluation is conducted by an independent organisation. Concerns included whether it is possible to disentangle the impact of specific regulatory interventions, and that creating new metrics to measure against specific PR24 aims is unlikely to be beneficial. We will be mindful of these concerns and adopt a pragmatic approach when carrying out this exercise.

2.6 Questions for stakeholders

Q2.1: Do you agree with the challenges facing the sector and the ambitions for PR24 we have identified?

Q2.2: Do you agree that continuing to use our three building blocks helps push companies to meet our ambitions for PR24?

Q2:3: Do you agree that we have struck the right balance between what's in and what's outside of the price control?

Q2.4: Do you have any comments on our approach to evaluating progress? What specific evaluation questions (based within the four key ambitions) do you think an evaluation should look to answer?

3. Design and implementation of price controls

3.1 Introduction and summary

In this chapter we set out our proposals for the design of the separate controls that we will set for different parts of the value chain for water companies. We propose to use a total revenue control approach for water resources, network plus water, and network plus wastewater and an average revenue control approach for retail and bioresources. We then set out some of the key policy proposals for the different controls. We explain how we are seeking to make use of markets and competition to complement our price controls to achieve better outcomes for customers, for example through using direct procurement for customers and in the provision of developer services.

This chapter is structured as follows:

- design of price controls (section 3.2);
- water resources (section 3.3);
- developer services (section 3.4);
- retail (section 3.5);
- bioresources (section 3.6);
- additional wholesale controls (section 3.7);
- revenue forecasting incentive mechanism (section 3.8); and
- direct procurement for customers (section 3.9).

Further information on topics covered in this chapter is set out in:

- Appendix 2: water trading incentive;
- Appendix 3: developer services;
- Appendix 4: bioresources control; and
- Appendix 5: direct procurement for customers.

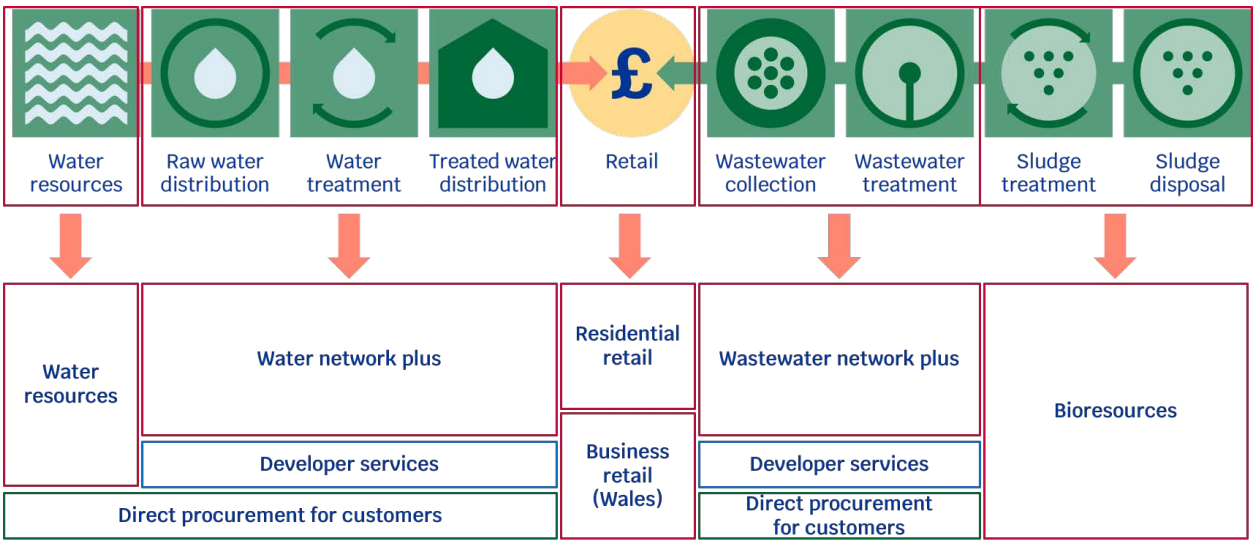
3.2 Design of price controls

The water sector encompasses a range of activities such as:

- Sourcing and abstracting water;
- Treating water to make it drinkable and transporting it to consumers;
- Providing retail services (such as customer information and billing);
- Taking away and treating wastewater; and
- Disposing of sludge.

These activities are diverse in a number of ways, for example, in terms of their capital intensity, the scope for using alternative delivery mechanisms, and how they can contribute to our ambitions for the sector. To reflect these differences, we set separate revenue controls[17] for different activities. Figure 3.1 gives an overview of water and wastewater activities and how these relate to the individual price controls and areas where markets can support delivery.

Figure 3.1 Water and wastewater activities



In our May 2021 discussion document we proposed to retain separate controls for PR24 in their current broad structure. Stakeholders were generally supportive of this proposal. We will therefore set the following separate revenue controls at PR24:

- water resources;
- network plus water;
- residential retail;
- business retail (for Welsh companies only);
- network plus wastewater (for wastewater companies only); and
- bioresources (for wastewater companies only).

There are also separate controls set in relation to the Thames Tideway Tunnel and the development of the Havant Thicket water resources scheme.

We set each revenue control on a 'single till' basis. This involves forecasting the efficient costs of companies and setting a revenue allowance which allows well managed companies to recover those costs for a basket of services, including charges to end customers.

[17] Although the generic term "price controls" is commonly used to describe what we are setting, the actual control relates to the revenue that companies can recover from their customers for carrying out these activities.

We propose to include a number of uncertainty mechanisms[18] which allow for adjustments to be made to companies' revenues or to their Regulatory Capital Value (RCV).[19] These adjustments may take place either 'in-period' (at the end of a given price control year) or at the end of the control period. We include these mechanisms to ensure that risks are properly allocated between companies and their customers and that customers' interests are appropriately protected. Adjustments can also improve company incentives (such as around their revenue forecast).

We propose to set the water resources, network plus water and network plus wastewater controls as total revenue controls. This means we set a fixed total amount of revenue that companies may recover from their customers for these activities. We propose to set the retail and bioresources controls as average revenue controls. This means we set an average revenue (for example per customer, in the case of retail) that the company may recover for providing these services. In both cases this allows companies flexibility in how they recover this revenue, provided they do not exceed the revenue cap.[20] We will set the revenue each company can recover[21] by determining:

- our assessment of efficient expenditure (referred to as total expenditure (totex)) during the 2025-30 period;
- the assessment of expenditure to be recovered within the period (set as the pay as you go (PAYG) ratio) and that which should be added to the RCV and recovered in the future by companies;
- returns on, and run-off of, the RCV;[22] and
- a tax allowance.

3.3 Water resources

Climate change, population growth and the need to reduce abstraction all put additional pressure on water resources. Water efficiency and reducing leakage provide part of the solution, as must better use of existing infrastructure, but it is clear that additional water resource infrastructure will be needed. Prior to PR19, we did not see sufficient progress in

[18] A summary of the mechanisms is contained in Appendix 11 – Allowed return on capital.
[19] Regulatory Capital Value represents a measure of the capital base of a company when setting price limits. It reflects the allowed expenditure to be recovered from future customers.
[20] In a simplified example, if a company serves 1,000,000 customers and is allowed an average revenue of £40, its cap would be £40,000,000. However, rather than charge each customer £40, it has flexibility in how it recovers the charges as long as the cap is not breached, for example by setting the price per unit for metered customers and the amount per rateable value for non-metered customers.
[21] Chapter 6 sets out our approach to assessing the efficient costs for the wholesale controls. Chapter 7 discusses how we will set an appropriate return for the wholesale controls, and our approach to tax. Chapter 8 sets out our approach to recovering costs, which determines the PAYG rates and RCV run-off for the wholesale controls.
[22] Expenditure added to the water resources and bioresources RCV since 1 April 2020 does not receive the same level of regulatory protection as that added prior to this date. For water resources we use capacity as the measure to distinguish between pre- and post-2020 investment. Our capacity measure is water resources yield. This captures the average volume of water available from the environment, dependent on the service level and planning period, and constrained by water resources control assets. This is a component of the standard supply-demand balance calculation water companies use for water resources planning.

companies taking forward new infrastructure solutions. That situation has begun to change, but there is still much to do. In PR24, we will:

- promote greater collaboration between companies and other water resources service providers to maximise the value of existing resources and incentivise the efficient development of new water resources solutions;
- encourage companies to make use of market mechanisms in water resources where these can deliver significant benefits for customers;
- incentivise companies to trade water with each other where this is better value than meeting their own needs alone; and
- continue to seek the best value solutions for water resource needs and find the right timing and choice of investments to provide resilient water supplies and protect the environment without imposing unnecessary costs on customers.

Each company is required to establish and maintain its water resource management plan (WRMP), which is subject to guidance from the UK government and Welsh Government.

3.3.1 RAPID

It is critical that water companies meet long term water resource challenges while promoting the best interests of customers, communities and the environment. In 2019 we, together with the Environment Agency and Drinking Water Inspectorate, established the Regulators' Alliance for Progressing Infrastructure Development (RAPID) to accelerate the development of new strategic water resource infrastructure and facilitate this through improvements to the regulatory framework. Natural Resources Wales is involved in an advisory capacity, with a decision-making role for any solution involving Wales, Welsh policy and legislation.

Water resource solutions are progressing through RAPID's gated process, supported by funding established as part of PR19. We want to see more progress on the delivery of strategic water resource solutions during the 2025–30 period, and propose to continue to use development funding and incentives to support this. We discuss this further in Appendix 9. We expect that before 2030, a number of solutions will be construction-ready, and we expect large projects to be taken forward through Direct Procurement for Customers (DPC).

We welcome the improved collaboration we have seen through this process and will continue to engage with the companies to ensure that the regulatory framework is supportive of the best value solutions being delivered and that companies are not inadvertently disadvantaged by doing the right thing. For example, as described below, we will provide incentives that reward companies that provide better value through running the DPC process effectively or through trading bulk supplies of water.

As the portfolio of water supply solutions is delivered, we anticipate there may be a greater scale of trading than in the past. We will ensure that the regulatory framework

accommodates this, for example in the treatment of costs at future price control reviews. More strategically, companies will need to consider potential future scenarios that may involve considerably more water trading and the need for greater integration of operations and planning. We expect that any solutions and contracts taken forward now will be designed to accommodate such potential changes.

3.3.2 Use of markets

Markets can play a valuable role in ensuring that companies meet or manage future demand for water. We expect companies to be innovative and ambitious in seeking ways to meet customers' needs for new water resources in an affordable and environmentally sustainable way. We propose **to retain the bidding market which allows third parties to bid to help companies meet and/or manage future demand for water**. This enables companies to actively consider a wider range of options, such as trades with neighbouring companies and third parties. We require companies to publish both water resources market information and a bidding framework against which they assess bids to provide water resources or demand management initiatives from third parties.

We are concerned that the current resource planning process does not sufficiently take account of third-party solutions. During the PR24 period we intend to **undertake a review of the effectiveness of the current water resources market arrangements**. This will assess how companies engage with third parties in their consideration of water resources options.

We **do not intend to take forward work on water resource bilateral markets in PR24**, and we will remove the bilateral entry adjustment mechanism (BEAM) for the PR24 period.[23] As noted in our May 2021 discussion document interest in the creation of bilateral markets is currently limited. Stakeholders did not object to our suggestion that we shouldn't prioritise work on this for PR24. We will review the prospect for bilateral market entry again before we undertake PR29,[24] and we may reinstate a BEAM when needed to support a future bilateral market.

3.3.3 Trading incentives

Water trading is one option available to companies when they consider how to ensure they have adequate water resources to meet the needs of their customers. Effective water trading

[23] Bilateral markets is the term for the proposed market model that would see third parties trade water resources directly with retailers in the business market (usually using an incumbent water company's network to treat and transport the water).
[24] Note that post-2020 water resources RCV remains at risk in the event of future bilateral market entry.

can lower costs for customers where it reduces or delays the need for developing more expensive infrastructure to meet this need.

Any new trades between Wales and England are subject to certain additional guiding principles, for example that the relevant company or companies must provide detailed analysis and explanation of the economic, environmental and multi benefits for Welsh citizens.[25]

Responses to the RAPID consultation[26] suggested that stakeholders consider that an effective incentive is needed to encourage water trades, including from new strategic infrastructure.[27]

The current water trading incentive[28] may not be suitable for future trades. These could be of a different type and scale. In future, we therefore need to either **adapt the current incentive** so that it can apply to all new trades, **or replace it with a new incentive** if that is a better solution. In Appendix 2 we set out details of two high-level options which we are considering for PR29:

1. Our preferred approach, which is an option that retains many of the features of the current incentive, adjusted to account for time-lags from new infrastructure build and the consequences of long-term contracts.

2. A different approach which regulates the charges for water transfers and allows a margin to incentivise trading.

We invite stakeholder views on these two options.

We propose to **retain the water trading incentive, in its current form, until the end of March 2030**.[29] As part of PR24 we will **commit to a revised incentive being in place for PR29** and will provide an outline of the form it will take.[30] Our approach will ensure we do not run two different incentives within the same price control period.

[25] Welsh Government, 'Guiding Principles for Water Companies Developing WRMPs', December 2021.

[26] Responses are published alongside 'RAPID - The regulatory and commercial framework for strategic water resource solutions – a consultation,' December 2021.

[27] The incentive is intended to encourage the trading of water. The incentive does not cover the delivery of infrastructure, which is dealt with separately.

[28] The current water trading incentive was introduced in PR14 and carried over into PR19. It allows both exporters and importers to financially benefit from trading surplus water. It is suited to relatively short-term trades that do not require significant new infrastructure to support them.

[29] We do not consider that there is a need to make changes to the incentive for the 2025-30 period as trades necessitating a change to the incentive will commence after this period. For any qualifying trade constrained by the incentive cap in the 2025-30 period, we would consider whether, for that trade alone, a continuation of the existing incentive could continue to allow the remaining incentive payments to be received in the 2030-35 period.

[30] On current information, we do not expect any trades from strategic water resource solutions to commence until the early 2030s, which will be the middle of the 2030-35 period. However, it is possible that companies might start construction during the 2025-30 period. As part of their investment case, they may require a degree of certainty about whether a trading incentive will be in place and the form which it will take.

3.3.4 Securing the legitimacy of large investments in new water resources

Business plan proposals in relation to water resources should be based on companies' water resources management plans (WRMPs),[31] which will establish the need for investment in supply-demand balance solutions. Following a recent change, English companies must plan to be resilient to a 1 in 500 year drought.[32] Companies in Wales also need to plan to be resilient to a 1 in 500 year drought if they are planning a new water transfer with an English company. Companies must meet the enhanced resilience standard and improve the environment, whilst also ensuring that customers do not overpay.[33] We expect companies, where available and more efficient, to consider using innovative technology and planned operational interventions as an alternative to new expensive infrastructure. We expect them to plan adaptively, including describing a core pathway based on no/low regrets investment and investment to keep future options open.[34]

As a statutory consultee in the WRMP process,[35] we will **apply elevated scrutiny to the forthcoming set of WRMPs** (which are expected this autumn). We will do this by applying relevant aspects of how we assess spending on new infrastructure in our assessment of WRMPs. We will also **carry out an additional check on utilisation risk for large water resource investments**. We want to be clear that they are the best value solutions under normal operating conditions. We expect companies to take full account of our comments on their draft WRMPs in producing final WRMPs, and for those final WRMPs to be reflected in their PR24 business plans. Whether WRMPs fulfil our minimum expectations will feed into our assessment of companies' business plans and will affect how each company performs under our PR24 Business Plan Incentives.

For PR24 business plans, we propose to treat investments in water resources assets in line with our general policy for water and wastewater assets, in terms of inclusion in the RCV. This means that, in a change from PR19, we will **not require companies to specify utilisation risk-sharing arrangements for large investments in water resource assets**. We expect companies to continue to optimise the use of their assets on an ongoing basis.

[31] Each company produces a new 25 year WRMP every five years. We discuss how companies should take account of the requirements of strategic planning frameworks such as WRMPs in Chapter 6 – Setting expenditure allowances.
[32] This needs to be met by 2039 with flexibility in timescales possible where costs are exceptionally high in comparison with benefits with a delivery by 2050 scenario expected to be presented.
[33] For water resource assets constructed in-house and added to the RCV, customers bear the risk of asset stranding if the assets are under-utilised (with the potential exception of cases in which under-utilisation is due to future bilateral market entry). Utilisation risk is also allocated to customers in the case of water resource assets delivered through DPC.
[34] Ofwat, 'PR24 and beyond: Final guidance on long-term delivery strategies', April 2022.
[35] This means that companies must consult with us when they develop their WRMPs. The UK government and / or the Welsh Government, as applicable, which has to approve a WRMP before it can come into effect, may take account of our views in reaching its decision on whether the WRMP meets the required standard.

3.3.5 Boundary of the wholesale water controls

A separate price control for water resources was introduced at PR19. In our May 2021 discussion document we sought views on the possible extension of the boundary of the water resources control to include assets that currently sit within the water network plus control. In November 2021 we published an open letter[36] which confirmed that, having considered stakeholder feedback, **we will retain the current boundary for the 2025-30 period**. While there may be benefits associated with changing the control boundary in future, they are not likely to be sufficient in the 2025-30 period to justify making a change now. We recognise that the current control boundary has been in place for a relatively short time, which means we do not have enough information on which to base a further change now. However, we may make changes at future price reviews to respond to developments in the water resources market.

3.4 Developer services

Developer services describes the activities delivered to connect new developments to the water and/or wastewater network. There are around 200,000 new connections every year across England and Wales. Developer services revenue accounted for 4.4% of network plus allowed revenue at PR19.

Developer services can be broken down into site-specific and network reinforcement work. Network reinforcement work is mostly delivered by the incumbent water company. But site-specific activities are mostly contestable and can be provided by the incumbent, a new appointee, or a self-lay provider (SLP). SLPs and new appointees can provide faster, more responsive services and lower prices than incumbents.[37] They can also sometimes provide developer services across utilities, reducing coordination issues.[38]

For PR19, developer services revenue and revenue from water customer bills are included in the wholesale water and wastewater network plus total revenue controls. This means that an unexpected increase in developer services revenue must be offset by a decrease in wholesale charges to comply with the revenue cap. This aims to protect developers from being overcharged as water companies would not benefit financially from overcharging them.

For PR19, we also:

- **Introduced a developer services revenue adjustment (DSRA) mechanism.** This adjusts allowed network plus revenue if the actual number of connections is more or less than forecast, mitigating volume risk.

[36] Ofwat, "Water resources price control boundary," November 2021.
[37] Ofwat, 'Review of incumbent company support for effective markets', August 2020, pp. 30-31.
[38] Ibid.

- **Introduced the developer services measure of experience (D-MeX).** To encourage water companies to provide good service quality to their new connections customers, SLPs and NAVs.
- **Included developer services revenue in the revenue forecasting incentive (RFI)** To encourage companies to engage with their new connections customers and accurately forecast developer services demand when setting charges each year.

We said we would revisit our regulation of developer services at PR24. To enable us to arrive at robust proposals, we have collected more granular data to better assess the state of competition in developer services. We have also reviewed our current approach to developer services regulation.

Our review of the state of competition in developer services found that:

- **Almost all wastewater site-specific developer services are delivered by developers and SLPs** rather than incumbent water companies.
- **The amount of water site-specific developer services work delivered by SLPs is growing, but remains limited in some regions and market segments,** particularly in new developments of 25 properties or fewer.

We also learnt several lessons from developer services regulation at PR19:

- **The inclusion of developer services in the network plus controls causes potential cost cross-subsidisation with water bill payers**, which may distort the market. It can also cause water bill volatility.
- **Developer services costs are more difficult to assess than other costs**.
- **Incumbent water companies have a financial incentive to encourage SLPs and NAVs to carry out developer services work.**
- **The DSRA does not account for in-period changes to the mix of high- and low-cost work** (ie work-mix risk).

We have developed our proposed approach to regulating developer services at PR24 in light of the above, and stakeholder responses to the high level options we presented in our May 2021 discussion document We also propose that D-MeX remains in PR24.[39] Our proposed approach is set out below, and a detailed assessment of the options we considered is presented in Appendix 4.

3.4.1 Network reinforcement

We propose that network reinforcement remains in the wholesale water and wastewater network plus controls because:

[39] See Appendix 6 – Performance commitments.

- It is almost entirely delivered by the incumbents, so competition is insufficient to protect new connection customers from monopoly power (eg higher prices).
- There are substantial interactions with other water company activities (eg capital maintenance) that do not facilitate accurate cost separation.
- There can be substantial temporal mismatch between costs and revenue because reinforcement may commence before work begins on a development site.
- We are interested in views on whether to apply a revenue reconciliation mechanism to network reinforcement investment requirements or if cost sharing is sufficient.

3.4.2 Wastewater site-specific developer services

We propose that wastewater site-specific developer services are excluded from the wholesale wastewater network plus price control because:

- Nearly all wastewater site-specific developer services are delivered by SLPs/developers. There appears to be no market power issue.
- Costs and revenue can be separated from other activities.

There are some instances where developer customers must use the incumbent wastewater company to provide wastewater site-specific developer services (eg on sites with access issues such as the need to cross a railway, where the incumbent needs to use its statutory powers). We are considering whether any changes to charging rules are needed to protect customers in these instances.

3.4.3 Water site-specific developer services

We see benefits in removing water site-specific developer services from the network plus price controls – it reduces the risk of cost cross-subsidisation with water bill payers and subsequent market distortions; and removes the need for complex cost assessment and reconciliation mechanisms. But we need to ensure that new connections customers are sufficiently protected in potential instances of monopoly power (eg higher prices).

We therefore consider a mix of markets and regulatory tools are required at PR24 to achieve effective outcomes in relation to water site-specific developer services.

We propose to exclude new developments of more than 25 properties from the wholesale water network plus price control at PR24. We intend to introduce transitional arrangements for companies with low levels of third-party activity in this market segment (eg only allowing companies to increase developer charges in line with the consumer prices index including housing costs (CPIH).

We propose that new developments of 25 properties and fewer should either:

- remain in the wholesale water network plus control; or
- be removed from the wholesale water network plus control but with alternative protections to protect new connection customers in this market segment from potential monopoly power (eg higher prices).

We are interested in stakeholder views on the relative merits of each of these options, and how we could achieve suitable customer protection through alternative non-price-control protections (eg through changes to our charging rules or applying an ex-post reconciliation mechanism).

3.4.4 Other work on developer services

We also regulate developer services through our charging rules for water and wastewater companies in England. We have made several important changes to the way English water companies[40] charge for developer services since 2018. Our changes have supported the connections market by improving the way companies set out their charges and making them more cost reflective. This has allowed SLPs and NAVs to compete on level terms with incumbent water companies and given developers and third parties greater opportunity to exercise their choices.

An important change to the way we regulate developer services is our decision to stop English companies offering income offset and to remove the balance of charges rule, from April 2025.[41] We conclude that there is no convincing justification for income offset, and that any discount or surcharge reflecting environmental or social issues should have a clear rationale. We discuss this in more detail in Appendix 3.

We are also considering the issue of developers paying for nutrient neutrality credits, which we discuss in Appendix 9.

3.5 Retail activities

Retail activities include the provision of customer services, managing bad debt and meter reading.[42] We first set separate price controls for companies' residential retail activities and for companies' business retail activities at PR14.

Our review of PR14 highlighted some of the advantages of separate price controls. We found that the separation of the residential retail control led to a focus on residential retail costs and significant efficiency improvements in some companies as well as service improvements.

[40] Water companies whose areas of appointment are wholly or mainly in England.
[41] Ofwat, 'Scope and balance of developer charges and incentives – conclusions', October 2021.
[42] We propose not changing the activities that are currently designated as Retail Activities. These activities were originally designated as part of the 2014 Periodic Review.

We also found that the separation of the business retail control was essential for facilitating the expansion of competition in the business retail market in April 2017 for customers of companies operating wholly or mainly in England.

Overall, we continue to consider that separate five-year controls for retail activities are in customers' interests. At PR24 we therefore propose to set:

- a price control for the residential retail activities of English and Welsh companies; and
- a price control for business retail activities of Welsh companies.[43]

Although our approach to assessing the costs for these sets of activities will be different from one another at PR24 (as set out in Chapter 7), to make the implementation of these controls as simple, clear and effective as possible, we intend the design of the controls to be as consistent with one another as possible.

Note that we have previously consulted stakeholders on our proposed approach to regulating companies' residential retail and business retail activities at PR24. For example, we consulted on the design of these controls in our May 2021 discussion document and engaged with members of our cost assessment working groups on a range of residential retail issues. Our proposals take account of this engagement.

3.5.1 Protecting retail customers not eligible for competition in England and Wales

Residential retail customers in England and Wales and business retail customers (other than water business retail customers using 50 megalitres a year or more) of Welsh water companies[44] are not subject to competition.

We propose setting an average revenue control based on the number of customers companies need to serve. This would be based on the retail cost to serve and net margin approach and would be expressed as:

- for the residential retail control of English and Welsh companies, an amount of allowed revenue for each residential retail customer; and
- for the business retail control of Welsh companies, an amount of allowed revenue for each business retail water customer and an amount of allowed revenue for each business retail wastewater customer.

[43] In recent years the English water companies for whom we set individual price controls have all chosen to exit the business retail market and no longer carry out business retail activities. Therefore, we will not set a price control for business retail activities of English companies at PR24.
[44] This reflects the current policy position of the Welsh Government.

This approach is simple and ensures that companies' revenue is linked to how many customers they need to serve (and therefore a key driver of their costs). We applied this approach for residential retail activities at PR19. This approach would be a simplification of our business retail controls at PR19 which allowed for a greater number of tariff bands.

We propose no automatic indexation of allowed revenue. This means that companies' allowed revenue would not change in line with the general level of inflation within the price control period. Instead, expected input price pressure would be reflected in the revenue limit we set for companies at the outset of the price control. We consider that this approach provides appropriate incentives for retailers to manage input costs given they are best placed to manage them. This is the same approach we took at PR19.

We are proposing a reconciliation to correct for any over- or under-recovery of revenue over the 2025 to 2030 period. This approach would ensure any imbalances are corrected in an appropriate and timely way. Any correction would incorporate a time value of money adjustment. This approach would be a simpler version of the approach we applied to residential retail controls only at PR19.

3.5.2 Protecting large business customers in Wales

For the largest water customers of Welsh companies who can switch their supplier, we propose to align our approach with the Retail Exit Code (REC) for large business customers served by English water companies who have been transferred to business retailers.

The current REC does not set specific price caps for premises using 50 megalitres a year or more of water. Instead, it requires default tariffs for this group to be reasonable and not to be unduly preferential or discriminatory compared to customers of the same class. Companies' licence conditions already ensure a degree of alignment.[45] However, we could consider additional steps, for example changes to charging rules, to ensure greater alignment to protect business customers.

We therefore do not intend to set a price control for supplies above the eligibility threshold. This approach aims to recognise competition in the market whilst giving some level of price protection for these customers.

The eligibility threshold for water retail competition (there is no wastewater retail competition) for business customers of Welsh water companies may increase. We expect the Welsh Government to consult on increasing the eligibility threshold. We propose ensuring customers below the eligibility threshold for competition are protected using the average

[45] Water companies are already subject to Condition E which prohibits setting charges in a way which results in undue preference in favour of, or undue discrimination against, any of its customers or potential customers.

revenue control described in the section above. Customers above the current eligibility threshold would be brought within the control if the eligibility threshold rises.

3.6 Bioresources

Bioresources (or sewage sludge) are the semi-solid by-products of wastewater treatment. Wastewater companies must ensure their bioresources are treated and disposed of appropriately. We set revenue controls for the bioresources activities of English and Welsh wastewater companies to protect the interests of customers as they cannot choose an alternative provider for this service.

We propose to set our revenue controls in a way that supports the bioresources market. Traditionally, sewerage companies have undertaken bioresources activities in house, but there are a range of market opportunities available to companies. We expect these market opportunities to help the sector to meet its potential to create economic and environmental value.

After identifying potential issues with the operation of the bioresources market, we launched our 'Review of the bioresources market' on 19 October 2020. In summary, although there seems to be a reasonable degree of competition for sludge transport and disposal, we found that there are a number of barriers preventing the bioresources market from reaching its potential.[46] Some of these barriers can be addressed by the way we regulate, so we have recently introduced improved information remedies, published additional guidance to improve the allocation of costs between companies' bioresources control and wastewater network plus control and taken steps to establish bidding market arrangements.

We have also continued to set a clear expectation on water companies to work together to address common issues where appropriate, mindful of competition law considerations. We have already seen some evidence of company collaboration, for example four companies covering the east of England are participating in an Innovation Fund scheme that will explore the benefits of greater trading and joint build.

Our proposed approach to regulating companies at PR24 will provide further support for the market in the following ways:

- **Setting an average revenue control based on the amount of sludge companies produced**. This approach would ensure that companies' revenue is linked to how much sludge they need to transport, treat and dispose of. An average revenue control would come closer to a 'gate price'[47] type of approach which is how waste is frequently charged for in the wider waste sector. This is different to the

[46] The findings of the bioresources market monitoring report 2020-21 supported this conclusion.
[47] Also known as a 'gate fee'. Gate fees are the charges for providing a range of waste treatment, recovery and disposal services. For other organic waste it is commonly expressed on a per tonne basis.

'modified average revenue' control we used at PR19 where much of companies' allowed revenue was fixed.

- **An approach to assessing companies' costs in a more market-based way.** We intend to assess a greater proportion of companies' costs through a single, benchmarking approach and set a separate efficiency assessment for bioresources activities. This would come closer to how a market would operate where competitors' costs are compared with each other by potential customers. Our approach to assessing companies' costs is set out in Chapter 7 on costs.
- **Setting an end-of-period reconciliation** to:
    - correct for any over- or under-recovery of revenue over the 2025 to 2030 period - this would provide an effective mechanism to incentivise companies to collect an appropriate amount of revenue and address any imbalances in a timely way; and
    - incentivise accurate sludge production forecasts over the 2025 to 2030 period – sludge production forecasts are needed to set an accurate average revenue control, so such an incentive is appropriate.

We expect companies to take a leadership role in developing the bioresources market and to fully exploit the opportunities it creates. **We expect companies' business plans to set out:**

- **a sludge strategy** – as part of this, companies should set out the steps they have already taken and are planning to take to address the expectations we set out in our bioresources market review[48] regarding greater sector collaboration where appropriate (and mindful of competition law considerations);
- **stretching cost forecasts** – this should take account of market opportunities and use appropriate benchmarks to demonstrate value for money; and
- **accurate sludge production forecasts** – companies should now be accurately measuring their sludge production and this should be appropriately reflected in production forecasts. Companies should set out how they have ensured the accuracy of their sludge production figures and how any steps they have taken to improve this have impacted their reporting of sludge production.

Further details of our proposals relating to bioresources are set out in Appendix 4. To help test and clarify how our proposals could work in practice and their potential impact, we plan to publish a supplementary document by 2 September 2022. This supplement will set out the type of data we would use and provide some example model results. It will draw on data provided alongside companies' Annual Performance Reports in July. To allow stakeholders to

[48] See p. 23 onwards. We set out expectations on sewerage companies to work with each other and the rest of the sector to address many of the issues identified in Jacobs' report. For example, regarding forming regional partnerships; research that could be best undertaken at sectoral level; and the development of sector level measures for sludge quality. We also set an expectation that companies consider other areas for working collaboratively, such as providing any additional market information in a standardised way and agreeing common processes or standards.

consider this supplement, we have extended the deadline for responses to our bioresources proposals to 5pm 16 September 2022.

3.7 Other controls

3.7.1 Havant Thicket

At PR19 we set a 10 year price control for the Havant Thicket Winter Storage Reservoir project. At PR24 we will undertake the planned mid-period review which will allow a reset to the efficient costs of development of the reservoir through a cost adjustment mechanism (as set out in PR19 final determination for Havant Thicket) and also expect to incorporate an update to the allowed return on capital and associated assumptions to provide a revised profile for the remainder of the 10 year control to 2029. In 2029, we will do a reconciliation once construction has completed.

3.7.2 Thames Tideway Tunnel

There are two separate price controls required for the Thames Tideway Tunnel (TTT) project. The first will be in Thames Water's licence for works Thames Water has undertaken. We will consult on amending Thames Water's licence so that at PR24 we can set a separate price control[49] for activities it undertakes in respect of the TTT. This will cover the period 2025-30. During this period we expect that Thames Water will undertake the commissioning of the TTT and begin operations. It will also continue to dispose of any surplus land acquired for the purposes of the TTT.

The second separate price control relates to the TTT itself. The construction works are currently being delivered by a separate licensed infrastructure provider (Bazalgette Tunnel Limited (Tideway)) and the control is not subject to review as part of PR24. It will, once completed, be subject to future price reviews, the first of which is expected to be PR29.

3.8 Revenue forecasting incentive mechanism (RFI)

At PR19 we put in place the RFI to ensure companies took responsibility for accurately forecasting the revenues they collect. It aimed to incentivise companies to collect the correct

[49] A separate price control for Thames Water's activities in relation to the TTT project, originally put in place at PR14 for the 2015-20 period, was set at PR19 to cover activities that Thames Water are undertaking during 2020-25. These activities are mainly associated with connecting the TTT with Thames Water's sewerage network.

amount of revenue and correct for under/over-recovery of revenues associated with demand forecasts.

We propose to set an RFI for the 2025-30 period in a similar form to PR19, however we are considering excluding developer services revenue. This is because we propose to exclude part of developer services from the price control (see section 3.4). D-MeX and our Code for Adoption Agreements will ensure that water companies continue to engage positively with developers. Consequently, this would mean that the RFI would:

- cover the water resources and network plus water and wastewater controls, but not the bioresources control, developer services revenue or retail controls;
- be a symmetric revenue adjustment applied in-period to true-up revenue differences;
- apply a financial penalty where differences between actual and allowed revenues are greater than 2% using the same approach to applying the penalty (the rate between ±2% and ±3% variance would be tapered and >±3% it would be calculated as the level of imbalance multiplied by 3%); and
- make a time value of money adjustment.

We consider that, given the proposed structure of the price controls, the behaviours that we want to encourage, and the potential benefits and risks identified are similar to PR19 there remains a strong case to retain the RFI in a similar form.

While it is not yet possible to analyse the impact of RFI, in PR14 Review: Discussion paper on findings, we noted that the WRFIM (which operated in a similar way to RFI during 2015-20) improved the accuracy of demand forecasts[50]. The RFI also acts as a 'correction mechanism' that allows companies to recover variance in different categories of revenue in later years (subject to financial incentive adjustments). Companies will continue to benefit from the additional protection against revenue variance, not available to companies in the wider economy.

We believe the proposed financial incentive provides an appropriate balance between providing a meaningful incentive for companies to manage revenue collection and recognising some variation is inherent in revenue forecasting. For context, we estimate calculated penalties of around £6m at a sector level in 2020-21, compared to revenue adjustments allowed through the RFI of around £250m.

We will continue to review the detailed operation of the 2020-25 period RFI ahead of the final determination in 2024, so that we can if necessary improve the RFI for the 2025-30 period to ensure that it operates as effectively as possible. We are considering how best to align the treatment of third-party costs and revenues, particularly the interaction between cost sharing and the revenue forecasting incentive**. We welcome views on whether there should be any changes to the RFI in relation to third party costs and revenues**. Our

[50] For wholesale water we found that the absolute variance between allowed and recovered revenues fell from 1.33% to 0.56% at PR14 and fell from 0.89% to 0.03% for wastewater.

view on excluding bioresources and developer services from RFI would be taken in light of wider responses on the proposals set out in sections 3.4 and 3.6.

3.8.1 Blind year revenue and un-invoiced revenue adjustments within the RFI formula

We propose including factors within the RFI formula in relation to blind year revenue and un-invoiced business retailer revenue.

We made some 2019-20 blind year revenue adjustments in-period using an additional factor included in the RFI formula. We intend to include a similar factor, with similar scope, to cover 2024-25 blind year revenue adjustments at PR24 (see also Chapter 10).

In September 2021 we consulted on proposals that would enable incumbent water companies to recoup relevant un-invoiced revenue for services provided to a retailer in the event of a retailer's unplanned exit from the business retail market. We consulted on the proposal that un-invoiced revenue should be subject to the relevant company's underperformance cost sharing rate before any amounts are recovered via an adjustment to the RFI. We plan to publish our final decision this autumn and propose that our decision should also apply to the 2025-30 period. If we decide to implement the proposal that was included in our September 2021 consultation, this would mean that the RFI formula notified in the PR24 final determination would include a factor to adjust for un-invoiced revenue.

3.9 Direct procurement for customers

DPC is a process whereby companies put major projects out to competitive tender for delivery by third parties. Competition for delivery provides good value for customers by driving down costs, while maintaining quality. The successful bidders for DPC projects, known as the Competitively Appointed Providers (CAP), will be responsible for designing, building, financing, operating and/or maintaining the infrastructure.[51]

At PR24 we expect companies **to use DPC by default for all projects above our DPC size thresholds**. This applies to all parts of the water and wastewater value chain, apart from bioresources. We propose that **the size threshold above which companies should use DPC at PR24 is around £200m of lifetime totex**.[52] We reserve the right to explore the use of DPC for major projects below this size threshold - for example, for major projects which

[51] Three Pathfinder DPC projects are currently being progressed under our DPC framework.
[52] At PR19 we used a size threshold of £100m lifetime totex. Companies may elect to use DPC below the revised £200m threshold at PR24 at their discretion. However, there may be lower net benefits for smaller schemes and we consider there is likely to be greater market appetite for schemes above the threshold.

pose delivery or financeability challenges because they are large compared with the size of the company.

Companies must make an assessment of the extent to which potential DPC schemes are separable and support this assessment with evidence. We are in the process of reviewing our engineering guidance for assessing which schemes are sufficiently separable for DPC and will make the revised guidance available prior to issuing our final methodology. As part of this review, we are considering whether certain types of investment can be considered separable by default.

Companies must estimate the value for money for customers of project delivery through DPC. A negative company estimate in the early stages will not be an acceptable reason to not pursue a DPC arrangement. This is because we consider that what represents value for money can only ultimately be determined by putting eligible projects out to tender. We reserve the option of allowing companies to deliver projects themselves if we consider that DPC procurement is not in customers' interests.

We will **not include funding for in-house delivery of DPC eligible schemes when we set price controls**. Instead, we will **allow funding for companies to run the DPC procurement process for eligible schemes**. In line with our current DPC framework, the costs of the CAP will be recovered from customers outside the price controls in accordance with an Allowed Revenue Direction.

We propose that our PR24 Business Plan Incentive will penalise companies that do not propose the use of DPC for eligible schemes. Further details are set out in Chapter 11.

Through new DPC guidance[53] and PR24, **we propose to implement a focused incentive package so that DPC schemes are delivered well**. This will involve incentivising companies with DPC schemes to run a good procurement process that is delivered on time and creates value-for-money for customers.

We plan to **review the existing DPC licence conditions to ensure that they are still fit-for-purpose**. We plan to **add these DPC licence conditions to the licences of companies with DPC eligible schemes at PR24** if they do not yet have these conditions in their licences. We anticipate that this will be done in late 2023 or early 2024.

More detail on our approach to DPC at PR24 is provided in Appendix 5.

[53] New DPC guidance is currently being developed for future DPC projects. They will replace the PR19 DPC procurement principles and DPC contract principles.

3.10 Consultation questions

Q3.1. Do you agree that in our final methodology we should commit to introducing either an adapted water trading incentive or a new water trading incentive at PR29? If you have a preferred approach, please provide reasons, including any thoughts on how the options we set out in Appendix 2 could be improved.

Q3.2. Do you agree with our proposals to:

a) Continue to include network reinforcement in the network plus price controls?

b) Remove wastewater site-specific developer services from the wholesale wastewater network plus price control?

Q3.3 Do you agree that the inclusion of network reinforcement in cost sharing would be enough to manage uncertainty around the volume and mix of network reinforcement work to be delivered?

Q3.4. For water site-specific developer services:

a) Do you agree with our proposal to exclude new developments of more than 25 properties from the wholesale water network plus price control at PR24, but with transitional arrangements for companies with low levels of competition?

b) Do you think that new developments of 25 properties and fewer should remain in the wholesale water network plus control or be removed? If they were removed from the price control, what alternative protections could we introduce to protect new connection customers from monopoly power?

Q3.5. Do you agree with our proposals:

a) To raise the size threshold above which companies should deliver schemes through DPC to around £200m lifetime totex?

b) For companies to deliver schemes through DPC by default above this threshold?

Q3.6. Do you have any views on any other aspect of our proposals in relation to:

a) The design of price controls;

b) Water resources;

c) Developer services;

d) Retail activities;

e) Bioresources;

f) Other controls;

g) The revenue forecasting incentive mechanism; or

h) Direct procurement for customers?

4. Reflecting an understanding of customers and communities

4.1 Introduction and summary

Business plans and long-term delivery strategies should be informed by high-quality research and engagement evidence, and, in Wales, the 'collaborative approach'. At PR24, we are asking water companies to explain how they will deliver the right outcomes, at the right time, to help meet long-term objectives for water customers, communities and the environment.

This chapter sets out our expectations of companies in relation to customer and wider stakeholder engagement. We aim for PR24 price review submissions and our decisions to reflect an understanding of customers' and communities' concerns, needs and priorities in accordance with expectations set out in the UK and Welsh Government strategic policy statements for Ofwat.[54]

4.1.1 Key messages

We expect price review submissions to recognise and address the needs and priorities of **current and future customers** and ensure that there is support for those who struggle to pay their water bills.

- It is vital that the **diversity of customers' and communities' needs, priorities and concerns** are understood so that companies' PR24 business plan proposals and long-term delivery strategies target the right outcomes at the right time. (Section 4.2.)
- Engagement with customers and wider stakeholders should focus on aspects of plans where customer views can have a **meaningful influence** and make sure that customers can be involved in a **meaningful way**.[55] (Section 4.3.)
- Working with companies and CCW we are **implementing a collaborative approach to some customer research for PR24**.[56] [57] This approach is being used in specific areas of research to inform common areas of business plans, including overall customer priorities and outcome delivery incentive (ODI) rates for most common performance commitments (PCs). We are also developing an approach for all companies to use when testing customers' views of the affordability and acceptability of business plans. (Section 4.3.1.)

[54] Including having due regard to our Public Sector Equality Duty (see section 149 of the Equality Act 2010).
[55] CCW report by Blue Marble, 'Engaging water customers for better consumer and business outcomes', May 2020.
[56] We are involving wider English and Welsh stakeholders, such as Defra, Environment Agency, Welsh Government and Natural Resources Wales via the governance arrangements for the collaborative research. See Appendix 1 of 'Collaborative customer research for PR24' for the terms of reference for the steering group(s).
[57] Note: the 'collaborative customer research' for PR24 involves all companies across England and Wales. The 'collaborative approach in Wales', explained in section 4.5 is the term used to describe the wider approach to involving Welsh stakeholders in the PR24 price review.

- Separately, we expect each company to undertake further engagement as necessary. This should ensure that the manner of fulfilling statutory requirements and **locally important priorities and the phasing of delivery of targeted outcomes are informed by customers', community and environmental stakeholders' views**. (Section 4.3.2.)
- Companies should be able to demonstrate they have met the **standards** for high-quality research, customer challenge and assurance of customer engagement.[58] (Section 4.3.3.)
- We are proposing **open challenge sessions**, to which customers and other stakeholders are invited so that they have opportunities to challenge companies on their plans directly in an open forum. (Section 4.4.)
- **In Wales, we are implementing a collaborative approach** to identify the high-level outcomes to be achieved in PR24 and the phasing of these outcomes across the long-term delivery strategies for Welsh companies. (Section 4.5.)

The remainder of this chapter provides more detail on each of the above areas.

4.2 Customers are central to PR24

Amongst other things, our price reviews must be conducted in the interests of consumers: we expect companies to demonstrate that they put the interests of current and future customers at the heart of the way that they run their businesses and their plans for PR24 and beyond. We expect price review submissions to recognise and address the needs and priorities of the generality of current and future customers. Water companies need to ensure that their plans are affordable, both now and into the long-term, and ensure that there is support for those who struggle, or are at risk of struggling, to pay their water bills. For the purposes of the price review, 'customers' are the end users, that is residential and business users of water and wastewater services. [59] [60]

Companies need to engage effectively with their customers and wider stakeholders to inform their PR24 business plans and long-term delivery strategies. Effective partnerships between companies and their customers and communities are also vital to addressing urgent challenges such as driving down water demand and reducing sewer blockages.

[58] Ofwat, 'PR24 and beyond: Customer engagement policy - a position paper', February 2022.
[59] Customers of eligible business premises in England and, to a more limited extent in Wales, can choose their Retailer; where this is the case, in general, these retail services are subject to separate regulatory arrangements under the business retail market and are not covered by the price review. Wholesale services are provided by the incumbent water companies. The provision of wholesale services (~90% of the final customer bill) and retail services which are not covered by the business retail market are covered by the price review to ensure business customers' interests are protected. For example, many of the common performance commitments (PCs) apply to the provision of wholesale services irrespective of whether the end customer is a residential or business user. We propose to introduce a new common PC in England (BR-MeX) capturing other aspects of wholesale services provided to business customers.
[60] Ofwat, 'PR24 and beyond: Customer engagement policy - a position paper', February 2022, p. 17.

Companies' plans need to be focused on delivering their legal obligations and the outcomes that matter to customers, communities and the environment, at a price that customers can afford, now and into the future.

4.2.1 Addressing the needs of customers in vulnerable circumstances

Having due regard to our Public Sector Equality Duty,[61] and in accordance with our principles of customer engagement,[62] we expect companies to understand and respond to the diverse needs of customers: we draw attention in particular to customers in vulnerable circumstances.[63]

On an ongoing basis, we expect companies to take effective action to identify and support customers:

- in vulnerable circumstances, including those who experience transient vulnerability
- who are struggling to pay their water bills or are at risk of struggling to pay their water bills.

PR24 business plans should be consistent with that expectation.

There is a great deal that water companies can do to **support customers who are financially vulnerable, in debt or struggling to pay**. We have published strengthened guidelines for how water companies should be dealing with household customers in financial difficulty.[64] We will also be considering vulnerability issues as part of our wider work on a customer-focused licence condition.[65] We welcome actions taken by some companies in recent months to increase support to customers struggling to pay. Companies do not need to wait for PR24 to make changes in this area.

Defra and Welsh Government are currently exploring CCW's recommendation of a **single social tariff** to help protect financially vulnerable households. Defra and Welsh Government have indicated that they would like the single social tariff to be implemented from 1 April 2025 to align with the next price review period. Any new scheme requires primary legislation which is subject to the Parliamentary timetables. Water companies will need to be mindful of Defra and Welsh Government's policy plans in this area and prepare accordingly. Chapter 10

[61] See section 149 of the Equality Act 2010.
[62] Ofwat, 'PR24 and beyond: Customer engagement policy - a position paper', February 2022, p. 17.
[63] Including, for example, those who are disabled or chronically sick, the elderly, those on low incomes and those in rural areas.
[64] Ofwat, 'Paying Fair Guidelines.'
[65] We are planning to introduce a new principles-based licence condition, which will provide a clear regulatory basis for the requirement for water companies to treat customers fairly, including by providing support to customers in vulnerable circumstances. Ofwat, 'Customer-focused licence condition.'

explains our expectation of how companies' price review submissions will take account of the potential introduction of a single social tariff.

We expect the Wales PR24 Forum to consider the balance between outcomes and affordability to customers as part of its programme of work, taking account of customers' views where appropriate.

4.3 Meaningful understanding of customers and communities

Engagement with customers and wider stakeholders should focus on aspects of plans where **customer views can have a meaningful influence** and make sure that **customers can be involved in a meaningful way**.[66]

At PR19, we found that companies had engaged with more customers than ever before, with many companies demonstrating high quality and innovative approaches. However, we also found problems with the quality of research approaches in some instances, meaning that we could not rely on the evidence. We also found the results from companies' research varied significantly on common issues, with no clear underlying reason for the differences.

We have developed our customer engagement policy for PR24 to address the issues we experienced at PR19, which limited our ability to take account of customer evidence.[67]

4.3.1 Some customer research is being done collaboratively

Working with companies and CCW we are implementing a **collaborative approach** to customer research for certain aspects of PR24.[68] [69] This approach is being used in specific areas of research to inform common areas of business plans. We are taking account of differences between the English and Welsh contexts as appropriate.[70]

[66] CCW report by Blue Marble, 'Engaging water customers for better consumer and business outcomes', May 2020.
[67] Ofwat, 'Collaborative customer research for PR24', October 2021, set out the rationale for our plan to work with CCW and companies to do collaborative customer research which will generate robust results at company-level and allow us to reliably understand differences in views between customers of different companies.
[68] We are involving wider English and Welsh stakeholders, such as Defra, Environment Agency, Welsh Government and Natural Resources Wales via the governance arrangements for the collaborative research. See Appendix 1 of Ofwat, 'PR24 and beyond: Customer engagement policy - a position paper' for the terms of reference for the steering group(s).
[69] Note: the 'collaborative customer research for PR24 involves all companies across England and Wales. The 'collaborative approach in Wales', explained in section 4.5 is the term used to describe the wider approach to involving Welsh stakeholders in the PR24 price review.
[70] See Appendix 1 of Ofwat, 'PR24 and beyond: Customer engagement policy - a position paper' for the terms of reference for the steering group(s).

A consistent approach to research is important where we need to achieve comparability of results across all companies. We expect companies to adopt the results of the collaborative research as they build their PR24 business plans.

Table 4.1: Research projects within the PR24 collaborative cross-sector customer research

Research subject[71]	
Customer priorities[72]	We are using this research to inform the development of performance commitments. We are also considering aspects of it in other areas of the price review development and our wider work.
ODI rates research	We are using this research to inform setting of each company's ODI rates for some common performance commitments. We also expect companies to use the results of this research, as far as possible, to inform any proposals for bespoke performance commitments and related ODIs. And companies may choose to use the customer valuations derived from this research to inform business cases for delivery of outcomes for which cost enhancement proposals are developed.
Affordability and acceptability	We are developing a research approach for companies to use when testing customers' views of the acceptability and affordability of their business plans and long-term delivery strategies ahead of submission.[73] Once the research approach is agreed: ▪ we expect that it will be adopted consistently by each company ▪ we will set out our expectations of evidence from companies that will demonstrate that the agreed approach has been followed. We also expect to reflect the agreed approach when developing the methodology for testing customers' views of our PR24 draft determinations, working collaboratively with CCW.

4.3.2 Some customer research is specific to each company

We expect companies to understand customers' views on the nature and phasing of delivery of statutory outcomes for PR24 and beyond and other priorities that are identified through engagement with customers, communities and environmental stakeholders.

We expect companies to conduct company-specific engagement to inform their proposals in a range of areas, including:

- Company-specific outcomes involving investment proposals/schemes
- Any bespoke performance commitments and related ODI rates
- Long-term delivery strategies

[71] We are publishing documents relating to the PR24 collaborative customer research approach on our website.
[72] Ofwat and CCW, 'Research on customer preferences: A joint report', April 2022.
[73] We expect the agreed approach to take account of the need for companies to explore two scenarios: i) the company proposals for offering support to customers that are struggling to pay their bills, and ii) introduction of the proposed Single Social Tariff.

- Where companies seek to deliver wider environmental and social benefits beyond their minimum statutory requirements and at a greater cost to customers[74]
- Company specific adjustment to the allowed cost of debt (if applicable).[75]

Companies' approaches to customer engagement to support development of plans should allow data to be collected efficiently. It should complement, and not detract from, engagement with customers to make sure day-to-day decision making and delivery is constantly improving.

We attach significant importance to the comparability and robustness of customer evidence to inform ODI rates across companies. We therefore strongly discourage any separate research by individual companies specifically to inform ODI rates for common performance commitments. This would duplicate the collaborative research described above and be a poor use of customer money. We will make a judgement on the weight we assign to any company specific research in our triangulation – which may be zero.

4.3.3 We expect companies to demonstrate they have met standards

We have published a position paper setting out **standards for research, challenge and assurance**.[76]

We have described standards that we expect companies to meet for:

- high-quality research;
- customer challenge of the nature, quality and use of customer engagement evidence; and
- assurance of the quality and use of customer engagement evidence.

We expect companies to be able to provide evidence that these standards have been met for engagement activities used to inform PR24 submissions, including but not limited to the areas of PR24 submissions mentioned in Section 4.3.2.

We are also making sure that the collaborative customer research for certain aspects of PR24 meets these standards by:

- our transparent and inclusive approach;[77]
- involvement of wider stakeholders and external research experts; and
- consideration of academic and other expert peer reviews of methodologies.

[74] See section 6 of Appendix 9
[75] See section A1.3 of Appendix 11
[76] Ofwat, 'PR24 and beyond: Customer engagement policy - a position paper', February 2022.
[77] We are publishing documents relating to the PR24 collaborative customer research approach on our website.

4.4 Hearing directly from customers and other stakeholders

The price review framework inevitably results in Ofwat hearing each of the water companies putting its case. We also hear from wider stakeholders who advocate for outcomes for the environment or long-term government priorities to be delivered, at least in part, through water company activities and investment.[78]

We want our price review decisions to be **better informed by the views of customers and communities** so that we understand:

- the key issues that companies should be taking into account as they develop their price review submissions, including affordability concerns; and
- whether the final business plan addresses customers' concerns and environmental priorities.

We are proposing **open challenge sessions**, which customers and other stakeholders can attend so that they have opportunities to challenge companies on their plans directly in an open forum.

We are working with CCW to develop the details of this proposal, including whether there is a role for CCW to facilitate the sessions on a consistent basis across all companies. At present, we think that two open challenge sessions for each company would be appropriate:

- One session should be conducted during the development of the business plan (during the period January to June 2023, depending on the timing of business plan development for each company). This would give companies the chance to revise plans to reflect views heard
- One session after the final business plans is submitted, so that we can take account of views expressed as we undertake our assessment of PR24 submissions (during October and November 2023)
- Invitations would be open, but we would encourage involvement of people representing customers' and local environmental concerns including but not limited to representatives of each company's customer challenge arrangements and members of CCW's 'challenge co-ordination group'
- The company would be required to give a brief presentation of their (draft or submitted) business plan. We may prescribe the nature or content of these presentations
- Customers and stakeholders would be encouraged to ask questions of, or challenge, the company on any aspect of their business plan
- Representatives of Ofwat and CCW would attend each open session
- Ofwat, CCW or an independent organisation would chair each open challenge session.

[78] Examples for PR24 include WINEP, transition to net zero, and climate change.

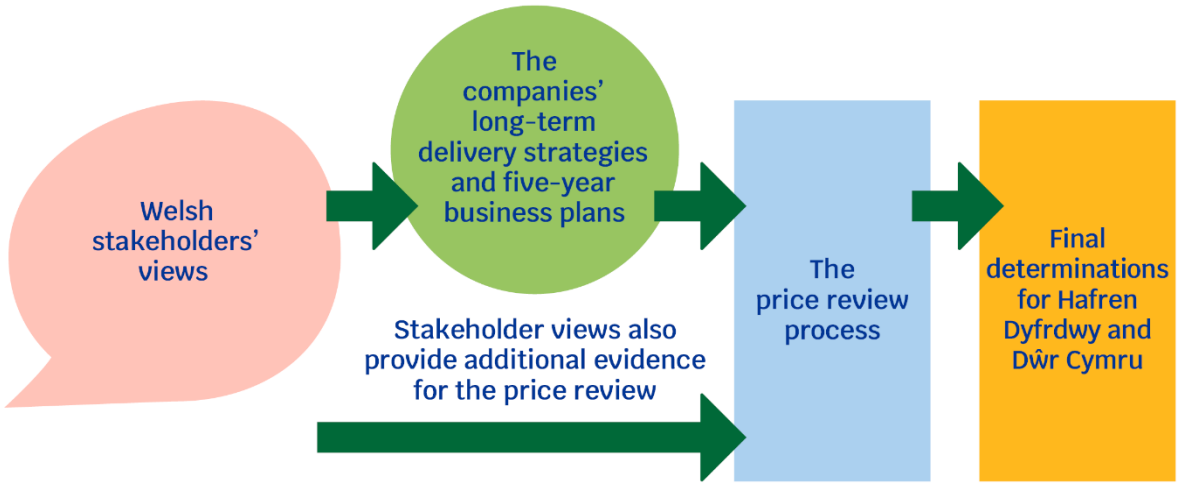
4.5 A collaborative approach in Wales

Although the regulatory frameworks and price review processes for water and wastewater companies in England and Wales are broadly similar, we should ensure that our ways of working reflect the circumstances in each country. For Wales, we take account of the Well-being of Future Generations (Wales) Act 2015 which places a particular focus on planning for the long-term and on outcomes that deliver for the environment, the economy and society.[79] It also focuses on meaningful engagement with stakeholders and an expectation on how this engagement should happen, with a focus on 'collaboration'.

We are implementing a **collaborative approach to identify the high-level outcomes to be achieved in PR24** and the phasing of these outcomes across the long-term delivery strategies for Welsh companies. This is mobilised through the Wales PR24 Forum.[80] We have set out the expected ways of working and how we will integrate the collaborative approach into the PR24 framework, and how this enables us to reflect the specific circumstances in Wales.

We see the collaborative approach in Wales as being an iterative process where the appropriate balance of outcomes can be discussed and developed. Figure 4.1 overleaf sets out, at a high-level, how this will happen, and how the collaborative approach will feed into the price review process:

Figure 4.1: The collaborative approach in Wales



We expect the collaborative approach in Wales to take account of customers' concerns about the affordability of business plans and long-term delivery strategies.

We will consider how we will align the open challenge sessions (mentioned in Section 4.4 above) for Dŵr Cymru and Hafren Dyfrdwy with the collaborative approach in Wales.

[79] Our overall PR24 approach also takes account of the National principles of public engagement in Wales.
[80] The following stakeholders are involved: Welsh Government, Natural Resources Wales, Drinking Water Inspectorate, CCW, Ofwat, Dŵr Cymru and Hafren Dyfrdwy

4.6 Consultation questions

Q4.1. Do you agree with our approach to making sure that companies' price review submissions and our determinations reflect an understanding of customers', communities' and environmental concerns?

Q4.2. Do you agree with our proposal to conduct open challenge sessions?

Q4.3. Do you have views on open challenge sessions can align with the collaborative approach in Wales?

Q4.4. Do you have views on how the outcome of collaborative customer research can contribute in the context of the collaborative approach in Wales?

5. Delivering outcomes for customers

5.1 Introduction and summary

The outcomes framework holds water companies to account for the outcomes that customers pay for and incentivises companies to go further where it is in the interests of customers and the environment. We do this by defining **performance commitments** (PCs) which measure the level of service provided for a particular outcome. Common performance commitments are measured for all companies in England and/or Wales, while bespoke performance commitments are specific to individual companies. We set the service standards we expect companies to deliver through **performance commitment levels** (PCLs). **Outcome delivery incentive** (ODIs) are the rates on which we base the underperformance payments for falling short of these service standards and the outperformance payments for exceeding them.

Key messages

We want a simple and powerful outcomes framework that focuses companies on delivering for customers, communities and the environment. We are proposing to:

- **Focus performance commitments on the key outcomes** – these are likely to be important in future price reviews as well as PR24. This includes a strong focus on **the environment,** as well as **customer service** and **asset health**, and include measures to encourage improved outcomes for **business customers**.
- Use **common performance commitments for most areas** of companies' performance - our proposed common performance commitments are summarised in Figure 5.1.
- Allow a **small number of bespoke performance commitments** where appropriate, for example to address an issue of specific local importance or because a company is performing poorly in an aspect of service that is not a key concern for other companies. Overall, we expect around **half the number of performance commitments there were at PR19**.
- Draw a **clearer link between cost allowances and the performance levels** we expect companies to deliver – more detail is given in Chapter 6.
- Have **powerful financial incentives on all performance commitments.** In general, these will apply symmetrically to out- and under-performance and be **based on customers' valuations** of the service attribute.
- **Allow enhanced ODIs** for very high performance to provide additional incentives to innovate. These will be applied to all companies on well-established performance commitments.
- Use an **aggregate sharing mechanism** to protect both customers and companies from very high payments, by reducing payments beyond certain thresholds. We propose to set caps and collars on some individual performance commitments on a targeted basis.

- Maintain **revenues at risk from ODIs equivalent to around a ±1 to ±3% return** on regulatory equity (RoRE) each year, excluding C-MeX, D-MeX and BR-MeX.

Figure 5.1: Proposed common performance commitments for PR24

	Water and wastewater	Water only	Wastewater only
Customers receiving excellent service every day	C-MeX (residential customer measure of experience) D-MeX (developer services measure of experience) BR-MeX (business customer and retailer measure of experience) [for English companies] Business customer satisfaction [for Welsh companies]	Water supply interruptions Compliance risk index (CRI) Customer contacts about water quality	Internal sewer flooding External sewer flooding
Environmental outcomes	Biodiversity	Leakage Per capita consumption Business demand (All three could be combined into a single water demand performance commitment) Operational greenhouse gas emissions - water	Pollution incidents Serious pollution incidents Discharge compliance Bathing water quality River water quality Storm overflows Operational greenhouse gas emissions - wastewater
Asset health		Mains repairs Unplanned outage	Sewer collapses

The chapter is structured as follows:

- Section 5.2 sets out our approach to performance commitments;
- Section 5.3 summarises our approach to performance commitment levels (which is covered in more detail in Chapter 6); and
- Section 5.4 sets out our approach to outcome delivery incentives.

Appendix 6 and Appendix 8 provide further details on our proposed approaches to performance commitments and ODIs respectively. They explain why we consider our approach appropriate, taking account of stakeholder views on the approach and alternative propositions. These views were provided in response to the discussion documents on performance commitments we published in November 2021 and April 2022, the discussion document on ODIs we published in February 2022, as well as through our Outcomes Working Group and the Future Ideas Lab.

5.2 Performance commitments

5.2.1 Overall approach to performance commitments

We want to focus performance commitments on the **key outcomes that are important to customers and the environment,** taking account of our statutory duties and the need to act in accordance with priorities and expectations set out to us in the UK government's SPS and Welsh Government's strategic priorities and objectives.

We propose to focus on outcomes that are suitable for **strong financial incentives**. We propose not to have performance commitments on outcomes that significantly duplicate or underpin other performance commitments. We also want to focus performance commitments on outcomes not outputs. As discussed in Appendix 9, where we cannot adequately capture the impact of enhancement expenditure through PR24 outcome measures (for example because it addresses a low probability event or because the benefits will accrue in PR29), we will use **price control deliverables (PCDs)** to track delivery instead.

We intend to use **tools outside the price review** to incentivise performance in areas that are not included within the outcomes package at PR24. This includes reputational incentives, licence conditions, charging rules and our enforcement powers. These tools allow us to be more flexible and responsive, particularly in areas where significant additional funding is not required. We will use additional performance information collected as part of our monitoring regime to support these tools. Companies should also collect, develop and report further metrics for their internal decision making and to communicate with their customers and other stakeholders.

The key outcomes in PR24 are also likely to be **important in future** and we intend to incentivise them in future price review periods. Companies should therefore be clear that investments made to improve these outcomes, and also failure to invest appropriately, will be recognised in future periods (see also sections 4.3 and 4.4 of Appendix 9).

We consider that **a performance commitment does not need to be fully in a company's control for it to be worth incentivising** company action to deliver its functions in the interests of customers. In many cases, companies can mitigate the impact of external factors such as **weather events**, on customers. **We do not think exclusions for such factors are appropriate.** In defining performance commitments, we have allowed some limited exclusions, where this does not compromise the companies' focus on outcomes for customers, communities and the environment, such as for coastal or fluvial (river) flooding. But we intend to design the performance commitment such that this is clear ahead of the final determinations and no detailed consideration is required ex post as part of annual reporting. We discuss how we intend to mitigate overall financial risks on companies and customers in section 5.4.4.

We propose that performance commitments which are common across all companies within a nation, which we term **common performance commitments, should cover most areas of companies' performance** - although the performance levels and incentive rates may vary by company. The common performance commitments will usually be the same in England and Wales, but differences may be appropriate in some cases (for example relating to strategic steers on long-term outcomes and priorities from the collaborative approach in Wales or to business customers where market structures differ). In some cases, a **small number of bespoke performance commitments** may be appropriate, for example to address an issue of specific local importance or because a company is performing poorly in an aspect of service that is not a key concern for other companies.

Overall, we are **proposing 21 common performance commitments for each water and wastewater company in England and Wales and 11 common performance commitments for each water-only company** (or 23 and 13 if we separately incentivise the water demand measures). These include a significant focus on the environment, as well as customer service and asset health. They also include new measures to encourage better outcomes in the business retail market in England. Allowing for a small number of bespoke performance commitments, we expect around half the number of performance commitments there were at PR19.

5.2.2 Excellent service for customers everyday

We are proposing that the customer service performance commitments remain broadly as at PR19.

However, we are proposing a new performance commitment for English companies measuring **business customer and retailer experience** ('BR-MeX') We are proposing BR-MeX to incentivise incumbent water companies (wholesalers) to take a more customer-orientated approach to help resolve frictions around data quality, wholesaler-retailer interactions and wholesaler performance. Our monitoring and review of incumbent support for the business retail market indicates that this needs to improve. These frictions continue to impede the development of a more effective business retail market and the delivery of better outcomes for business customers. We are proposing that BR-MeX is based on feedback from both business customers and retailers. We provide more details in Appendix 6, including our proposal for the market operator (MOSL) to administer the performance measure during the 2025-30 period. We propose to retain a common performance commitment for business customer satisfaction for Welsh companies, where the retail market is much more restricted, and we will develop this further with Welsh stakeholders.

We expect to maintain **customer and developer satisfaction metrics** at PR24, although we are proposing **minor amendments to C-MeX**. This includes removing the check and challenge process. We are also considering the use of online panels and the number of communication channels required. However, we only have one year's full reporting for the

PR19 C-MeX and D-MeX at this stage. We will therefore **continue to review the effectiveness of these measures** as more data comes to light and will consult on further changes ahead of our final determinations where appropriate. We will also consider reviewing D-MeX if we change our approach to regulating developer services (Section 3.4).

5.2.3 Protecting and enhancing the environment

Through PR24, we will drive a step change in delivery for the environment. In developing performance commitments in this area, we have considered the consultations from Defra on their proposed environmental targets under the Environment Act 2021[81] and storm overflows discharge reduction plan.[82] We will continue to consider the finalised targets and plans in our development of policy ahead of the final methodology.

We propose to add a range of environmental common performance commitments to those we used at PR19, including **performance commitments to incentivise improvements in biodiversity and reductions in operational greenhouse gas (GHG) emissions**. We propose that the former aligns with an established metric developed by Defra and the latter is based on the existing definition used in companies' Annual Performance Reports.

We also propose to **introduce a common performance commitment for serious pollution incidents**, in addition to the PR19 performance commitment on overall number of pollution incidents. This reflects the increasing concerns of customers and other stakeholders over pollution incidents, enabling us to apply stronger underperformance payments for serious incidents.

We are proposing **new common performance commitments on bathing water and river water quality**. We are working with stakeholders to develop these performance commitments. We are also proposing to include a **performance commitment to reduce the impact of storm overflows**. We will work with stakeholders to consider if there are reasons for this to differ in England and Wales to reflect the differences in legislation in this area,[83] while bearing in mind that there are advantages in having common performance commitments across England and Wales to help benchmark and challenge companies. Any material differences in operating and legislative circumstances will also be reflected in the PCLs and ODIs we set for individual companies.

[81] Defra, 'Consultation on environmental targets,' May 2022.
[82] Defra, 'Consultation on the Government's Storm Overflows Discharge Reduction Plan,' March 2022.
[83] While the Welsh Government and UK government are aligned on the overall challenge we face to improve water quality, Welsh Government's approach is to focus action on an integrated, evidence, outcomes and standards based approach to improve water quality. This approach is consistent with the Welsh requirement to achieve the Sustainable Management of Natural Resources (SMNR) and with Welsh Government's strategic objectives and priorities. Defra has proposed long-term targets that include stopping environmental harm from storm overflows and not spilling above an average of 10 rainfall events per year per storm overflow by 2050.

We will consider whether any further performance commitments are required to support a more **outcomes-based approach to the Water Industry National Environment Programme** (WINEP). We are working with the Environment Agency to test and establish the management and governance frameworks necessary to operationalise this approach. We are keen to do the same in Wales and are discussing with Natural Resources Wales whether an outcomes-based approach would be appropriate for elements of the National Environment Programme (NEP). This is consistent with Welsh Government's strategic objectives to adopt an outcomes-based approach and with the requirement in Wales to achieve the Sustainable Management of Natural Resources (SMNR). Natural Resources Wales is also supportive of this direction of travel.

We propose that **performance commitments designed to reduce water demand should cover business customer demand,** in addition to leakage and household customer demand (per capita consumption). We are **considering whether to set three separate performance commitments or combine them into a single water demand performance commitment**. A combined performance commitment would be more robust than the separate components, as it can be directly measured while the components are primarily based on company estimates. However, leakage has significant salience and customers may see it as distinct from consumption. In either case, we would expect companies to report against all four measures. We welcome views on this issue.

5.2.4 Maintaining and improving asset health

As we set out in our April 2022 discussion paper on operational resilience, we are proposing to **use the same asset health performance commitments as at PR19 – mains repairs, unplanned outage and sewer collapses**. We intend to complement them with further monitoring outside the price review, to form a holistic and complete view of asset health and operational resilience.

5.2.5 Bespoke performance commitments

We consider that bespoke performance commitments may be appropriate where:

1. there are local circumstances that do not apply to most other companies and there is compelling evidence that a performance commitment is required to provide incentives to drive benefits for customers, communities and the environment; and
2. a company provides poor service on a common issue where other companies' performance is generally adequate and the risk of deterioration is low (such a performance commitment is likely to have underperformance payments only)

We will also consider other cases where a company has compelling evidence that there are company-specific circumstances which mean a bespoke performance commitment will lead

to significant additional benefits for customers that are unlikely to be realised without it. These circumstances could result from responding to strategic steers on long-term outcomes and priorities from the collaborative approach in Wales.

As with common performance commitments, bespoke performance commitments should be suitable for financial incentives.

Based on our experience from previous reviews, we **expect at most two or three bespoke performance commitments per company at PR24**. Where possible, we propose to use standardised definitions and may require all other companies that don't have the performance commitment to report on these metrics so that we have comparable information across companies.

We propose that companies provide an **early submission for bespoke performance commitments**. This is to enable companies to take account of feedback on their draft definitions and include fully developed proposals for any bespoke performance commitments in their business plan submissions. We propose that companies **provide any proposed definitions for bespoke performance commitments in April 2023**.This should include compelling evidence of why a bespoke performance commitment is in the interests of customers and the environment. The definition of the performance commitment should be clear, unambiguous, complete and as concise as reasonably possible. Companies should demonstrate that the scope of the definition will help to provide appropriate incentives to deliver for customers, communities and/or the environment. We intend to provide feedback on draft bespoke performance commitment definitions in July 2023. Companies should take this into account in their business plan submissions. We do not propose to provide feedback on PCLs or ODI rates.

5.3 Performance commitment levels

PCLs set out the level of performance that we expect companies to deliver over the price control period. We expect companies to propose **stretching but achievable PCLs** in their business plans.

At PR24 we intend to draw a **clearer link between the cost allowances and the performance levels** we expect companies to deliver. This should drive greater service improvements for customers and the environment by reducing the risk that PCLs for each company are set too low or too high. We set out our proposed approach for setting PCLs for PR24 in Chapter 6, including our expectations on **common level and company specific performance commitment levels**, how we expect companies to account for the impact of base and enhancement expenditure and our **expectations of performance improvements over time**.

5.4 Outcome delivery incentives

ODIs align the interests of companies and their investors with customers and the environment by directly linking performance with expected financial returns. For PR24, we want powerful and streamlined ODIs.

5.4.1 Setting standard rates

We propose that **all performance commitments have financial underperformance and outperformance payments** (except where outperformance is not possible such as for statutory compliance performance commitments or where a bespoke performance commitment is needed to address poor performance in an area).

We want these payments to provide powerful incentives on companies to focus on performance, taking account of the **value to customers of each aspect of service**. We also want to set rates in a **consistent way between companies**, while allowing for material differences in customer preferences.

We consider that **outperformance and underperformance rates should generally be symmetrical**. Where there are risks that significant outperformance would not benefit customers, we consider outperformance caps are sufficient (see section 5.4.4).

We propose to set standard rates by applying a benefit sharing factor (X%) to the estimate of marginal benefits (MB) to a company's customers of a particular outcome, so that:

$$Standard\ ODI\ rates = MB * X\%$$

We generally expect to set the benefit sharing factor at 70% for all companies. We propose to **calibrate final rates for each performance commitment during the determinations phase of PR24** based on considerations such as:

- the degree of confidence in the estimates of marginal benefits;
- wider benefits or strategic priorities;
- information on marginal costs; and
- our approach to cost sharing rates.

While the marginal benefit estimates for individual performance commitments may vary between companies, we generally expect to set a common benefit sharing factor across companies.

If we do not obtain sufficiently reliable estimates for marginal benefits, for example for asset health, we may consider alternative approaches, including top-down approaches.

We also expect to **cross-check final rates** against potential returns on regulatory equity (RoRE) to ensure there are sufficient and proportionate incentives on companies for each performance commitment.

We will take a **different approach for measures of experience performance commitments** (C-MeX, D-MeX and BR-MeX) as these performance commitments do not measure absolute performance. We are proposing to set ODIs depending on relative performance, as we did at PR19 for C-MeX and D-MeX, with outperformance payments for companies that score above the median score and underperformance payments below this.

We are **considering increasing the overall incentive size for C-MeX,** to further focus companies on improving their customer service. The range of C-MeX payments in PR19 is ±12% of allowed residential retail revenue, equivalent to around ±0.33% RoRE on average (including higher payments, for those companies that compare favourably to other sectors). We invite views on this.

We are proposing to **retain the PR19 incentives design for D-Mex**. The allowed up to 6% of that year's actual developer services revenue for outperformance payments and underperformance payments of up to 12%. We are proposing that the **BR-MeX incentives** equate 0.5% to -1% of wholesale revenue collected from business customers. We set out our proposals further in Appendix 6 and Appendix 8.

5.4.2 Valuing marginal benefits

We propose that the **collaborative customer research (see Chapter 4) is the basis for marginal benefit estimates for almost all common performance commitments**, except for biodiversity and operational greenhouse gas emission performance commitments (and measures of experience performance commitments). For biodiversity and operational greenhouse gas emission performance commitments, we intend to use credible external valuations. We expect to publish initial customer valuations from the collaborative research in autumn 2022, with valuations mapped to common performance commitment definitions by winter 2022-23.

When estimating **marginal benefits for bespoke performance commitments**, companies should conduct research that is broadly consistent in approach to the collaborative customer research for common performance commitments and in line with the results where appropriate. This could be in collaboration with other companies and stakeholders. We expect companies to achieve the standards for conducting high-quality research set out in our PR24 customer engagement policy.

5.4.3 Enhanced incentives

Enhanced ODIs encourage innovation to deliver major performance improvements beyond the best level currently achieved by any company. They enable us to set more stretching performance levels in future price reviews, benefiting the customers of all companies. For PR24, we are proposing to apply **enhanced incentives to all companies for selected common performance commitments.**

We are also proposing that **enhanced ODIs are outperformance only**, reflecting the sector-wide benefits from very high performance, and that **enhanced thresholds and rates are set on a consistent and streamlined basis**. We propose that enhanced thresholds for each performance commitment are beyond the current frontier, informed by historical and forecast performance, with the aim to only reward companies for performance that is delivered through genuine innovation. We are also proposing that enhanced incentive rates are set at twice the size of standard rates. We are considering not setting enhanced caps at PR24, as enhanced payments will be included in our proposed aggregate sharing mechanism (see section 5.4.4). A company that achieves enhanced outperformance payments in PR24 is also likely to earn standard payments in the following period if it continues to outperform other companies, as we intend to maintain our approach to setting PCLs using a sector benchmark at PR29 (see section 5.4.5).

We propose that enhanced ODIs apply to common performance commitments that meet the following criteria:

- **clear benefits** to customers from very high performance;
- **well-established performance commitments** that enable us to set robust enhanced thresholds;
- **limited company-specific factors** associated with performance, so all efficient companies have a similar chance of meeting the threshold – in most cases, this should be where performance commitments have a common PCL; and
- **no perverse interactions** with the wider price review framework, such as significant enhancement cost allowances for some companies, or the bidding process for greenhouse gas emissions reductions, which may risk customers paying more than they should for improvements.

To ensure the customers of all companies ultimately benefit from enhanced ODIs, we propose that **companies that achieve enhanced performance will be required to share the knowledge behind their success with the sector** in a timely, open and transparent manner. We will claw back payments in future price reviews, or earlier, if we consider a company's knowledge sharing activities are inadequate.

5.4.4 Assessing and managing risk

ODIs encourage companies to assess and manage risks by exposing them to the consequences of service performance. We want to ensure that companies are strongly incentivised to do this but not disproportionately exposed to financial risk. We also need to protect customers from outperformance payments that are higher than expected.

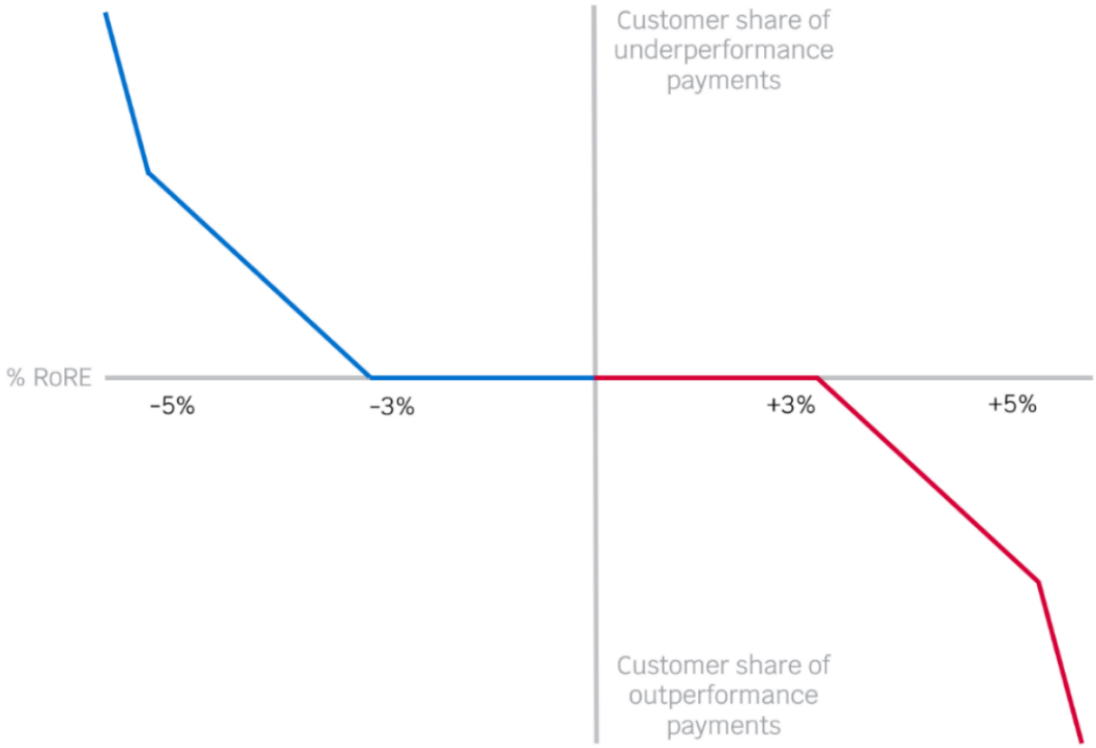
We expect **revenues at risk from ODIs to be between ±1 to ±3% return on regulatory equity (RoRE)** each year. This excludes potential payments from the measures of experience performance commitments (C-MeX, D-MeX and BR-MeX). We are **consulting on our approach to estimating risk** at PR24 – see section 5.3 of Appendix 8.

Risk exposure can be managed by caps and collars on individual performance commitments, which limit the financial impacts of performance beyond a given threshold. We propose to **only use caps and collars on a targeted basis**, such as for new or bespoke performance commitments, for which it is more challenging to set appropriate levels, or where the benefits from high outperformance are uncertain. We propose to set the levels of caps and collars using a 'top-down' approach with reference to the expected return on regulatory equity (RoRE). We are **proposing to not use deadbands** for any performance commitments.

For PR24, we intend to manage ODI risk primarily at an aggregate level. We propose to use an **aggregate sharing mechanism that shares net ODI payments between customers and companies** once they reach certain thresholds each year. This reduces (but does not remove) the financial impacts of very high or very low performance.

We illustrate how this new mechanism would work in Figure 5.2 overleaf. As a starting point, we propose that companies can earn or incur up to +3% or -3% RoRE without any sharing of payments, beyond which payments are reduced by 50%. Beyond +5% and -5% RoRE, payments would instead be reduced by 90%. We may adjust these thresholds to ensure the overall level and skew of risk is appropriate. We propose that the aggregate sharing mechanism applies separately for payments relating to the wholesale water and wastewater controls, and excludes C-MeX, D-MeX and BR-MeX payments.

Figure 5.2 – Illustrative aggregate sharing mechanism



5.4.5 Incentivising outcomes beyond PR24

We consider there are merits in providing long-term certainty about the outcomes framework, so that companies invest and explore new ways to deliver performance improvements over multiple price reviews.

We are **committed to maintaining the outcomes framework in future price reviews**. We expect the outcomes we are incentivising at PR24 to be of enduring interest to customers and the environment, and we expect them to be financially incentivised in future price review periods. We expect future PCLs, which drive future ODI payments, to be set using a sector benchmark. This means top performers in the current period should continue to earn outperformance payments in future periods (see Chapter 6.)

We have considered whether to provide greater certainty over incentive rates in future price control periods. This would reduce our flexibility to reflect changes in customer preferences over time. Companies should be clear that if they stretch themselves and perform better than others in future price control periods, they will gain outperformance payments. Conversely if they fall behind, they will pay underperformance payments. In general, therefore, we are not minded to provide greater certainty over incentive rates in PR29. However, we are open to proposals to provide greater clarity over our intended approach in PR29 where it can be demonstrated that this would clearly be in the interests of customers.

5.4.6 Implementing payments

We propose to apply **all ODI payments annually** through in-period revenue adjustments. This will include relevant adjustments for inflation, taxation and the time value of money, broadly similar to our detailed approach at PR19.

Companies are able **to request to defer the impact of ODI payments between years** to help manage affordability issues and cashflows, and we are proposing to retain this at PR24. For PR19 we suggested ±1% RoRE at an appointee level for when we would consider allowing deferrals. We welcome views on whether we should set out similar criteria at PR24, as well as how we could streamline the overall in-period determinations process.

We are proposing to consider end-of-period payments for bespoke performance commitments only where a company can demonstrate that the impacts on customers are expected to be realised over multiple price control periods, and that it does not significantly reduce management focus on these service areas or add disproportionate complexity.

5.5 Consultation questions

Performance commitments

Q5.1. Do you agree with our proposed package of common performance commitments? Is water demand best incentivised through separate performance commitments on business and household consumption and leakage or through a performance commitment measuring total demand?

Q5.2. Do you agree with our proposed guidance for bespoke performance commitments?

Standard incentive rates

Q5.3. Do you agree with our proposed approach to setting standard rates?

Q5.4. Do you agree with our proposed approach to the measures of experience performance commitments, including to increase the size of C-MeX?

Q5.5 Do you agree with our proposed approach to estimating marginal benefits for common and bespoke performance commitments?

Q5.6. Do you agree with our proposed approach to incentivising asset health performance?

Enhanced incentives

Q5.7. Do you agree with our proposal to retain, expand and streamline enhanced incentives?

Q5.8. Do you agree with our proposed approach to selecting performance commitments for enhanced incentives?

Q5.9. Do you agree with our proposed approach to setting enhanced thresholds, rates and caps?

Q5.10. Do you agree with our proposed approach to knowledge sharing?

Assessing and managing risks

Q5.11. Do you agree with our proposal to set caps and collars on a targeted basis, and apply a two-sided aggregate sharing mechanism to all companies?

Q5.12. Do you agree with our proposal to not set deadbands on any performance commitment?

Q5.13. Do you agree with our proposed approach to estimating ODI risk?

Incentivising outcomes beyond PR24

Q5.14. Are there instances where providing greater clarity over our intended approach to incentive rates in PR29 would clearly be in the interests of customers? Please explain why and provide supporting evidence.

Implementing payments

Q5.15. Do you have any comments on our proposed approach to implementing and streamlining payments at PR24?

Q5.16. Do you have any wider comments about the ODI framework at PR24?

6. Setting expenditure allowances

6.1 Introduction and summary

In this chapter we set out our expectations of companies for their expenditure proposals for PR24. To meet government, stakeholder and customer expectations, water companies will need to deliver significant improvements in performance over the 2025-30 period. To fund these improvements, we need to set appropriate expenditure allowances.

Water companies have historically spent around £10 billion per year. This directly impacts on customer bills. Setting efficient cost allowances helps to protect customers from paying more than they should for their water and wastewater services.

The way we set expenditure allowances and the expectations we place on companies on submitting expenditure proposals will be critical for water companies delivering additional value through PR24. It will directly contribute to the delivery of our goals of an increasing focus on the long term, delivery of greater environmental value and driving improvements through efficiency and innovation, as well as helping to deliver the needs of customers and communities.

Our aim is for customers to receive the levels of service they expect and are entitled to at an efficient cost and affordable price. Our draft methodology builds on and takes account of responses to our May 2021 document, assessing base costs at PR24 document,[84] responses to the Future Ideas Lab[85], as well as discussions at the cost assessment working group.

Key messages

Our approach to expenditure assessment for PR24 will help enable companies to meet challenges now and into the future.

- Companies will need to deliver a step change in efficiency. We will support this through our expenditure assessment with a greater focus on benchmarking and strong incentives for companies both to submit efficient business plans and to deliver those plans efficiently (see section 6.2).
- Companies need to deliver resilient services. Customers have funded and will continue to fund companies to be resilient. But customers should not pay again for past underspending or under delivery (see section 6.3).
- Companies need to deliver improved service to customers and the environment from expenditure allowances to keep water affordable. Our expectations of the improvements

[84] Ofwat, 'Assessing base costs at PR24,' December 2021.
[85] Ofwat, 'Future Ideas lab', 2022.

across efficiency and outcome performance will be stretching but achievable (see section 6.4).

- Companies need to plan over the long term and use adaptive planning to identify what needs to be done in 2025-30, and what decisions should be scheduled in future periods where there will be greater certainty. We will provide companies with sufficient funding to meet statutory requirements, government targets and customer needs, while encouraging the most efficient companies to go further and faster (see section 6.5).
- Companies should deliver best value. This will require companies to take account of wider environmental and social benefits, costs, risks and affordability of customers' bills when developing their enhancement proposals (see section 6.6).

6.2 A step change in efficiency is needed to allow the sector to do more

While the water sector showed relatively strong productivity post privatisation with growth of 3 to 4% per year between 1994 and 2000, it appears to have stagnated since 2011 with weak growth since then. [86,87] In PR19 we introduced measures to improve water sector productivity such as the £200 million innovation fund, a greater emphasis on markets, where appropriate, and incentives to deliver improved efficiency through cost sharing. We expect companies to use these measures to deliver a step change in efficiency both in their PR24 business plans and throughout the 2025-30 period. Only through this will the sector be able to deliver the improvements required by government and regulators in an affordable way.

We do not expect customers to pay for companies' inefficiencies. For PR24 we will continue to use a combination of catch-up efficiency, where less efficient companies catch-up with efficient companies, and frontier shift efficiency, where we expect even the most efficient companies to improve efficiency from improvements in working practices and the introduction of new technology. We will set catch-up efficiency based on our view of an appropriate efficiency benchmark.

For PR24 we propose to use the same overall approach to setting efficient expenditure allowances as PR19, and will use a combination of benchmarking models, cost adjustments and deep dive assessments, split across base and enhancement expenditure.

Base expenditure is routine, year-on-year expenditure, which companies incur in the normal running of their businesses to provide a base level of service to customers and includes expenditure to maintain the long-term capability of assets, as well as expenditure to

[86] Water UK study shows around 0% per year growth 2011 to 2017. Frontier economics for Water UK, Productivity improvement in the water and sewerage industry in England since privatisation, 2017, p. 3. Note this does not fully account for changes in quality.
[87] ONS multi-factor productivity data shows water sector productivity growth of -1.8% per year 2009 to 2021. This compares to an average of 1.1% per for manufacturing and 0.4% for the economy. ONS, Multi-factor productivity estimates, April 2022.

improve efficiency. To identify efficient base expenditure, we will use econometric benchmarking models, which use statistical methods to compare costs between companies on a like-for-like basis. These models consider multiple factors that drive differences in costs which are largely beyond a company's control such as company size, population density and treatment complexity.

For PR24 we intend to build on our PR19 benchmarking models. Given the broad support for the models at PR19, we have a high bar for changes. For the wholesale water and wastewater network plus base models, we are considering additional cost drivers based on company recommendations, alternative ways of assessing growth expenditure, and the extent to which we consider forecast as well as historical expenditure. Our wholesale water and wastewater network plus efficiency benchmark could be more stretching than upper quartile and could consider forecast as well as historical efficiency information.

For our residential retail models, we are proposing to simplify our approach by relying only on top-down aggregate cost models. At PR19, our top-down models performed better than bottom-up models and produced similar results. We will only consider using the bottom-up models where there is a demonstrable reason to do so. We will review how we model the impact of deprivation on companies' bad debt costs.

We are collecting additional cost data and intend to publish an updated base cost modelling data set in Autumn 2022 and propose to consult on our and company model proposals in Spring 2023.

Enhancement expenditure is generally where there is a permanent increase or step change in the current level of service to a new 'base' level and/or the provision to new customers of the current service. Enhancement funding can be for environmental improvements required to meet new statutory obligations, improving service quality and resilience, and providing new solutions for water provision in drought conditions.

For all enhancement expenditure requests we will consider the need, optioneering, cost efficiency and customer protection evidence presented by companies. In PR19 for most enhancement expenditure we used unit cost and simple econometric models largely based on forecast data to set efficient expenditure allowances. We will build on this approach for PR24 and, where appropriate, will use historical and forecast expenditure to set efficient expenditure allowances. For the remaining expenditure where costs are material, we will use engineering deep dive assessments to identify an efficient cost allowance.

We expect companies to ensure that schemes are procured and delivered as efficiently as possible. As set out in Chapter 4, we propose that companies use **direct procurement for customers** for all schemes above £200 million threshold. (See section 3.9)

Markets can drive innovation and efficiency for the benefit of customers and the environment. Consistent with the UK government's SPS, **we are proposing an approach to**

further promote the bioresources market at PR24. We propose firstly, to set an efficiency challenge tailored to the bioresources control to help drive efficiency and second, to capture more costs through our econometric cost benchmarking modelling. We will retain appropriate regulatory protection for pre-2020 regulatory capital value (RCV), consistent with our commitment at PR19.

Where possible, we will use **external benchmarks** to assess water sector efficiency. In PR19 we used external benchmarks to assess retail bad debt and customer service costs. We intend to use a wider set of external cost benchmarks for PR24 and take these into consideration when setting the efficiency challenge.

In an exceptional case, where a company considers that the benchmarking models do not fit its specific circumstances, it can submit a **cost adjustment claim** and provide evidence as to why it is different. Companies will need to provide compelling supporting evidence for any cost adjustments. We will continue to have a high evidential bar. For PR24 we are providing greater clarity on our expectations and placing a greater emphasis on two sided adjustments for factors reflected in historical expenditure. We are collecting additional data to facilitate this.

Companies will need to submit stretching business plans in terms of efficiency. Companies that do not submit stretching business plans or submit poor quality cost adjustment claims will not receive the highest rewards for business plans.

Cost sharing is where over- and under-spending relative to cost allowances is shared between companies and customers. This incentivises companies to be efficient and shares risks with customers. We are proposing to simplify cost sharing rates for PR24 so that rates are more symmetrical, sharing cost risks between companies and their customers, and to have less variation in the rates between companies. Companies that submit the poorer quality business plans will receive the least favourable cost sharing rates and will bear more of the costs of underperformance. We propose that the following rates apply across the four business plan assessment categories:[88]

- Outstanding - 50:50;
- Standard – 50:50;
- Lacking ambition – 55:45; and
- Inadequate – 60:40.

[88] Throughout this section we refer to cost sharing rates in the following format (x:y) where 'x' captures the applicable cost sharing rate on overspend compared to PR24 cost allowances and 'y' captures the applicable cost sharing rate on underspend compared to PR24 cost allowances.

6.3 Companies will need to be resilient to deliver the required improvement in services

Resilience is the ability to cope with, and recover from, disruption and anticipate trends and variability, in order to maintain services for people and protect the natural environment now and in the future.

Resilience is a priority of both the UK and Welsh governments. We expect companies to provide resilient services for customers today and over the long term.

Resilience has always been part of our regulation of the water sector. Water companies have a duty to maintain a water supply system and provide a wastewater system, so that they continue to meet their statutory security of supply and service obligations. These are legal obligations, which water companies must fulfil. Company business plans must reflect these obligations. Alongside our other statutory duties, we have a duty to act in the manner we consider that is best calculated to further the resilience objective.[89,90]

We fund companies to be resilient over the long term through a combination of base and enhancement expenditure. Both water resources management plans and drainage and wastewater management plans have resilience at their core and allow companies to identify enhancement investment required to maintain resilience over the long term. In PR19 we set our base allowance using historical costs and used forecast cost drivers to account for future changes in the asset base. Historical allowances have been sufficient for companies to maintain and improve outcomes and asset health measures over previous periods.[91]

We are evolving our monitoring approach to provide a richer picture of operational resilience and improve our understanding of asset health. While the outcomes regime captures a company's failure to mitigate risks when they have an impact on service, it focuses on performance at a point in time. Therefore, it may not always provide the breadth and depth of information needed to gain insight into the effectiveness of a company's approach to maintaining assets or managing current and future risks. We are therefore developing an integrated monitoring framework to provide a more complete view of asset health and operational resilience. In our Operational resilience discussion paper we set out proposals to explore and test wider measures associated with the health and performance of water and wastewater assets.[92] This should better help us to understand operational resilience and asset health risks going forward, and improve insight on compliance with legal obligations.

[89] This is to secure the long-term resilience of water companies' water supply and wastewater systems and to secure that they take steps to enable them, in the long term, to mee the need the need for water supplies and wastewater services.
[90] The general statutory duties for most of our work as an economic regulator are set out in section 2 of the Water Industry Act 1991.
[91] Ofwat, 'Assessing base costs at PR24', December 2021, pp. 50-51.
[92] Ofwat, 'Operational resilience discussion paper', April 2022.

For PR24 **we are proposing to include more of a forward look in our base expenditure modelling**. We already include forecast cost drivers in our base cost models so that allowances reflect future changes in scale, density and complexity of water and wastewater treatment. We are collecting additional data where treatment complexity might increase in the future so we can take this into account when setting efficient expenditure allowances. For example, due to phosphorous removal and ultraviolet treatment.[93] We will also consider whether we can take account of forecast expenditure data in our base expenditure models.

Companies address most of their resilience risks through base expenditure allowances. We therefore expect companies to continue to undertake these activities. Companies have made improvements to asset health within base cost allowances in the past and we expect them to continue to do so in the future. We are open to considering company evidence on additional exogenous factors / cost drivers that require a step change in efficient capital maintenance expenditure through the cost adjustment claim process. Cost adjustment claims should not be used to make up for previous underinvestment or under delivery.

We will fund investment to improve resilience. Base expenditure allows companies to continue to deliver performance improvements in business planning and maintenance to improve resilience. Planning for and delivery of water resources management plans and drainage and wastewater management plans will also make a significant contribution to enabling companies to be resilient. However, these do not cover managing increases in all hazards companies are exposed to. We therefore propose to amend the definition of resilience enhancement line so that companies can request investment to manage increasing risks from hazards that are beyond their control and not covered by other enhancement areas. We expect any such requests for investment to be set in the context of a long-term risk management plan, be supported by customers and be prioritised considering affordability. Where reducing system vulnerabilities addresses multiple hazards, within and beyond management control, costs should be proportionally allocated. To improve the quality of claims, we have set out further guidance on our expectations for the evidence we expect to see to allow enhancement expenditure in Appendix 9.

6.4 Companies need to deliver improved service to customers and the environment from expenditure allowances

We expect companies to set out business plans that will efficiently deliver the long-term requirements of customers and the environment in line with their legal duties. The future service levels companies pledge to deliver for customers and the environment are quantified through performance commitment levels (PCLs).[94] **We expect companies to identify**

[93] Ofwat, 'IN 22/02 Cost assessment data requests', April 2022.
[94] Further detail on the development of PR24 performance commitments and ODIs is included in Chapter 5. This chapter includes discussion of setting of PCLs for performance commitments.

stretching but achievable performance commitment levels (PCLs) in their business plans.

Companies should demonstrate ambition to deliver improving performance levels and affordable bills. We discuss our goal to incentivise all companies to propose stretching levels of performance for customers, communities, and the environment further in Chapter 11.

At PR24 we intend to draw a clearer link between cost allowances and the performance levels we expect companies to deliver. We will set PCLs for each performance commitment (PC) by determining the level of performance we expect an efficient company to deliver. To do this we will consider companies' baseline performance levels (ie 2024-25 starting point), the level of performance improvements deliverable from base expenditure, and the impact of enhancement expenditure on performance.

We have developed **several key principles for determining performance levels an efficient company can deliver through our expenditure allowances**. We expand on four high-level principles in the paragraphs below and provide further detail of our approach in Appendix 9. We expect companies to take account of our approach when developing their own long-term forecasts of the performance improvements they can deliver. These forecasts should inform companies' PR24 business plans and long-term delivery strategies.[95] Companies should ensure their forecasts are consistent with the delivery of Government and statutory requirements and reflect customer views.

1. **We will consider if companies should be expected to deliver a common or company-specific level of performance for each PC.** Our starting position is to assess for each PC whether companies can be expected to deliver a common level of performance. Setting common PCLs aids comparison across companies, helping to set efficient and stretching performance, and makes expectations clear across the sector.

   We consider a reasonable starting assumption is to expect a common level of performance from base expenditure given our base cost models include explanatory variables that cover a range of exogenous factors that impact companies. Some companies therefore receive a higher expenditure allowance than others in part because of the additional challenges they face in delivering services to their customers. Adjusting for these factors in our performance expectations as well as our efficient cost allowance would double count their impacts.

   We acknowledge that our base cost models may not reflect all drivers of differential performance. We will therefore consider setting company specific performance commitment levels when performance is materially affected by an exogenous factor not captured in our base cost models and/or differences in historical enhancement expenditure allowances. We expect companies to provide compelling evidence to support

[95] Our draft business plan tables detail the forecasts we expect companies to submit.

any claims to adjust the performance level expected to be delivered by its base expenditure from a common to a company-specific basis.

For certain performance commitments we expect all companies to deliver full compliance. The two common performance commitments for PR24 that we propose to apply this approach to are compliance risk index (CRI) - measuring drinking water quality compliance - and discharge compliance.[96] For these measures we expect the same level of service to be delivered for customers, communities and the environment. This aligns with the established outcomes required by other regulators and is consistent with companies' legal duties.[97, 98]

2. **We expect efficient companies will continue to improve performance over the long term from base expenditure.** Companies should challenge themselves to deliver more over time for customers and the environment through their base expenditure allowance. Our analysis at PR19 demonstrated that cost-efficient companies were able to deliver performance improvements from base funding.[99] We have observed companies improving performance through a focus on, and management of, key performance areas. For example, we observe that industry average performance in water supply interruptions and pollution incidents has improved by 52% and 73% respectively over the 2012-21 period.[100] Customers should not have to provide additional funding to receive this improved service.

3. **We will consider the overall stretch across cost and service and account for the performance of efficient companies when setting PCLs.** We intend to review the level of performance expected by companies across all common performance commitments in-the-round. This will identify if the levels set are suitably stretching when considered in the context of efficient expenditure allowances and historical performance. When reviewing historical performance, we would not expect an individual company to perform well across all performance commitments. This reflects company focus, strengths and weaknesses.

   When setting a rate of performance improvement expected of efficient companies, it is important to maintain the incentive for companies to outperform. In general, where we have confidence in an outturn performance dataset for a PC which demonstrates a spread of performance across the sector, we would not expect to adopt frontier performance as a basis for setting PCLs. This allows better performing companies to retain outperformance

[96] See Appendix 6 for further details on proposed PCs.
[97] Drinking Water Inspectorate, Environment Agency and Natural Resources Wales.
[98] Section 37 WIA and section 94 WIA (as supplemented by Regulations 4 and 5 of the Urban Waste Water (England and Wales) Regulations 1994).
[99] Ofwat, 'PR19 final determinations – Overall stretch on costs, outcomes and cost of capital policy appendix', December 2019.
[100] Based on the industry median.

benefits between investment periods, incentivising performance improvements over the long-term.

4. **We will adjust PCLs to account for enhancement expenditure where necessary.** When setting a PCL for 2025-30 we will first consider the level of performance improvements expected to be delivered through base expenditure. We will then adjust PCLs to take account of enhancement expenditure allowances using business plan evidence. Many enhancement investments, particularly best value ones, will deliver additional benefits that will improve performance across a range of performance commitments. We expect companies to identify and quantify these additional benefits in their PR24 business plans to enable us to account for them when setting PCLs. This protects customers from paying twice for the same performance improvements.

6.5 Facilitating efficient investment over 2025-30 and the long term

This section outlines what we expect from companies at PR24 and how we are supporting and facilitating investment and delivery for the long term. This encompasses:

- Planning needs and outcomes over the long-term;
- Delivering long term targets quickly and efficiently;
- Facilitating efficient long-term investment; and
- Ensuring delivery for customers and environment over the long term.

Planning investment and outcomes over the long term

Planning investment over the long-term is critical in ensuring that statutory requirements, government targets and customer needs are achieved in a sustainable and cost-effective way. To help facilitate long-term investment planning and outcome delivery we have introduced **long-term delivery strategies** which will be presented as part of companies' PR24 submissions.[101] These strategies should set the long-term context for how the five-year business plan and associated investments will deliver for customers both now and in the future (over at least 25 years). We expect long-term delivery strategies to form a key part of the evidence to justify the need for enhancement expenditure in 2025-30 and provide early sight of future investments. Companies in Wales should be able to demonstrate that their long-term delivery strategy and five-year business plan reflect the outputs of the collaborative approach in Wales as well as learnings from wider stakeholder and customer engagement.

Companies already have several **long-term strategic planning frameworks**. These frameworks include water resources management plans (WRMPs), regional water resource plans and drainage and wastewater management plans (DWMPs). These frameworks are

[101] See Chapter 10.

complemented by the water industry national environment programme (WINEP) in England and the national environment programme (NEP) in Wales. The outputs from strategic planning frameworks will need to inform, and align with, each company's long-term delivery strategy and business plan.

We have set out our expectations for WRMPs and DWMPs.[102] These include our expectations that plans are adaptable,[103] optimised over the long term, consider a wide range of options, are best value and take account of customer and stakeholder views and partnership approaches. We will continue to engage proactively in the development stages of these strategic planning frameworks. We expect companies to reflect our expectations and feedback in their final WRMPs, DWMPs and WINEP/NEP plans. We will take this into account, together with any differences between final plans and business plans, when we assess expenditure proposals and business plans.

The water industry strategic environmental requirements (WISER) from the Environment Agency and Natural England, and Natural Resources Wales's Expectations Document (draft due to be published July 2022) provide the frameworks for protecting and enhancing the environment in England and Wales. Companies will need to deliver environmental schemes where they have a legal duty to do so, in a way which meets that duty but also delivers best value for customers overall, by being in line with customers' views and priorities and remaining affordable.

Environmental requirements set out in WISER and Natural Resources Wales's Expectations Document will be delivered through the WINEP and NEP processes. We will work closely with companies and environmental regulators during the WINEP/NEP development. We want companies to maximise the benefits that can be delivered across all their environmental programmes, with a focus on both outcomes that have statutory drivers and linking to companies' core activities. Non-statutory improvements will need to be justified against our enhancement assessment criteria, including clear evidence of customer views on the proposed investment and outcome.

We support a move towards a more outcomes focussed WINEP/NEP. This is consistent with the approach that we try to take for other enhancement expenditure. Under this approach we set the outcomes we expect companies to deliver and then the efficient totex allowances needed to support the delivery of these outcomes. We are working in collaboration with the Environment Agency to move to a more outcomes-based approach to the WINEP and would support a similar approach in Wales.

[102] Ofwat, 'Ofwat's expectations for strategic planning frameworks at PR24', November 2021.'
[103] Ofwat, 'Final guidance on long term delivery strategies', April 2022.

Delivering long term-targets quickly and efficiently

Clear long-term targets set a firm direction for improvements. However, there can be uncertainty over the best way for the sector to meet some of these targets. We set ODIs to incentivise companies to go beyond their PCLs where it is efficient for them to do so. However, there are two areas where we do not have clear cost information and want to push the sector to make improvements as quickly as possible. Firstly, to reduce greenhouse gas emissions and second, to reduce spills from storm overflows and improve river water quality. We have therefore taken additional steps to drive this and allow companies to make faster progress towards meeting long term targets.

On **net zero**, for PR24 we expect companies' plans to make substantial progress towards national government net zero targets and want to see concerted action to address both operational and embedded emissions in parallel.[104] Some companies have already made reductions in greenhouse gas emissions through existing expenditure allowances. We therefore expect all companies to deliver further improvements through base expenditure during 2025-30. We also expect companies to deliver enhancement activities in a way that reduces the impact on emissions, for example through nature-based solutions where these are appropriate and evidenced as best value.

We want companies to go further than this and propose specific net zero enhancement investments. We expect to set a common reduction level for operational emissions and allow the efficient expenditure to meet this target. Where companies have proposed to go beyond this target, we propose to consider bids on a competitive basis through setting a net zero challenge which will allow additional net zero enhancement funding to drive further sector improvements, but we will concentrate this funding on only the most efficient companies. This will ensure that the additional, further, faster improvements are made at the lowest cost. And the learnings from these investments would be shared over the period, allowing all companies to implement these lower cost solutions in future periods.

We want companies to make rapid progress in addressing **storm overflow spills**[105] and to move towards government long term targets.[106,107] Meeting these targets will require improvements in operations and maintenance regimes as well as prioritised efficient investments. We expect companies to reduce spills from storm overflows from base and enhancement expenditure, both during 2020-25 and over 2025-30. We are currently conducting investigations into how all water and wastewater companies in England and Wales are managing their wastewater treatment works and we reserve the ability to revisit our PR24 methodology in light of relevant findings.

[104] Ofwat, 'Net zero principles position paper', January 2022.
[105] Ofwat, 'Letter from David Black to CEOs on Environment Act duties', March 2022.
[106] Defra, 'Consultation on environmental targets', March 2022.
[107] Defra, 'Consultation on the government's Storm Overflow Discharge Reduction Plan', March 2022.

Several companies have set themselves targets for the reduction in storm overflow spills by 2025. For example, Anglian Water, Northumbrian Water, Severn Trent Water and South West Water have committed to reaching an average of 20 spills per overflow by 2025. We expect all companies to reduce spills in advance of PR24. We therefore propose that all companies should deliver an average of no more than 20 spills per overflow for 2025 and go further where their legal duties require. Companies should provide compelling evidence if they consider an alternative target is appropriate for their circumstances.

Companies have been funded during the current 2020-25 period, in general to comply with their legal obligations and, in line with their WINEP/NEP programmes, to reduce the impact of storm overflows. They have also been funded to undertake investigations to determine whether further reductions are needed in storm overflow spills through enhancement expenditure in 2025-30. In England, given the proposed UK government targets, companies need to make progress as quickly as possible. Companies should go beyond what is revealed by the investigations planned for 2020-25 period and that may otherwise be included in their PR24 WINEP programmes on storm overflows, in particular to address environmental harm from high priority overflows.[108] This is as well as ensuring they are complying with their legal obligations. We therefore expect companies to undertake additional work during 2020-25, and to put forward robust proposals for PR24 to reduce spills from storm overflows, drawing on and coordinating with the work undertaken as part of the DWMP process. In Wales, we expect companies to propose storm overflow investments where there is evidence that they will improve river water quality, that is not already funded. Investment plans should consider nature- and catchment-based solutions, where they can be demonstrated to be an effective solution.

We expect to continue the **Innovation Fund** in PR24. Since it launched in 2021, we have awarded more than £63 million to 41 innovative projects. While it is early days for the projects, we have seen a significant increase in levels of collaboration between regulated companies which is stimulating greater levels of innovation and is helping to reduce the total cost of innovation in the sector.

Following the positive feedback to the April 2022 consultation on the future of the fund,[109] we will work with the sector over the coming months to look at how the fund can continue to stimulate innovation to help meet the strategic challenges facing the water sector.

Facilitating efficient long-term investment

We want to **facilitate efficient long-term investment** so the right interventions are delivered, and investments sequenced appropriately. We are proposing to do this in this methodology in five ways: a focus on Direct Procurement for Customers (DPC – see Chapter 4), facilitating multi-period investments, funding appropriate preparatory work, the

[108] High priority overflows, as defined in the government Plan for storm overflows
[109] Ofwat,'Innovation fund consultation – Approach for 2022-25', April 2022.

continuation of strategic regional water resources development funding through a streamlined gated process, and the retention of transition funding.

Some investments span multiple price control periods, notably where schemes take several years to design, construct and commission. Companies have suggested that this can create risks around the treatment of future funding. We have identified risks with cost over or underspending and delivery across price control periods. We are keen to **facilitate multi-period investments**. Where these schemes are delivered through DPC (or Specified Infrastructure Projects regulations, SIPR), risks associated with these long running investments will be mitigated through contractual arrangements. For other multi-period schemes, we want to allow companies to deliver schemes efficiently while protecting customers. We therefore propose that incentive arrangements apply separately to each price control period. For the proportion of the scheme scheduled to be delivered in 2025-30, companies would be subject to cost sharing and delivery risk during 2025-30. For the proportion of the scheme scheduled to be delivered in subsequent periods then companies should request a new expenditure allowance, based on updated evidence on scheme costs (but would not be able to request additional costs for elements scheduled but not completed in the previous period). Further details are set out in Appendix 5. In exceptional circumstances, for very large schemes where DPC is not suitable, we will consider company proposals for bespoke arrangements where they are in customers' interests and are required for the scheme to proceed.

We propose to allow **enhancement funding in cases where preparatory work is essential** to start work on schemes even where there is still uncertainty of need. This would apply where schemes are multi-period and preparatory work is needed in advance of confirmation that the scheme is required. We would expect all cases to be identified in long term delivery strategies and associated with an adaptive pathway. Preparatory investment for activities such as pre-planning application activities or part-delivery of the scheme, would be over and above normal option investigation, development, and appraisal activity, which is covered through base expenditure allowances. Companies should clearly identify where these requests are made and link these to the long-term delivery strategies.

As set out in Chapter 3, we propose to continue to allow funding for **the development of strategic regional water resource solutions**. This is expected to be for fewer schemes and subsequently less costs than at PR19. The funding will be applied to a streamlined gated process. Further details are set out in Appendix 9.

We propose to maintain a **transition funding programme** under which we will allow companies to bring forward some planned investment from the relevant regulatory cycle (eg 2025-30) to the final year of the previous regulatory cycle (eg 2024-25). The purpose of the transition programme is to make efficient use of resources and minimise whole life costs. This will apply where it is efficient to bring forward an investment, and to enable statutory deadlines early in the next regulatory period to be met.

Ensuring delivery for customers and the environment over the long term

We want to ensure that customers and the environment are protected from the non-delivery of funded schemes. The outcomes regime already provides a degree of protection to customers as ODIs give money back to customers where an outcome is not reached.

We expect companies to identify how customers will be protected against under or non-delivery of funded enhancements. This will either be by identifying clearly quantified impacts of enhancements on performance commitments (common or bespoke) and accounting for these in proposed PCLs. Or where the investment is material, but the outcome cannot be directly linked to a performance commitment – by setting a Price Control Deliverable (PCD).

Price control deliverables will allow enhancement funding to be returned to customers in the event of under- or non-delivery of outputs or outcomes associated with enhancement expenditure. These outputs or outcomes are not reflected in performance commitments and ODIs. Price control deliverables can apply to direct outputs or benefits of investment such as the primary driver of the scheme such as volume of water delivered or wastewater storage. They can also cover wider benefits such as scheme related embodied carbon emission reductions. Price control deliverables should cover each of the key outputs or benefits identified for enhancement proposals. If these outputs or outcomes are not delivered then the price control deliverable will return the associated enhancement funding to customers,

Price control deliverables should also be used to identify benefits from enhancement funding that are expected to be delivered after the end of the next price control (ie after 2030). This should encompass not only direct outputs but also the expected impact on performance commitment levels. Reflecting these benefits in price control deliverables will provide customers the transparency of expected future deliverables and companies with additional regulatory certainty over how our outcomes regime may take account of these benefits in PR29. Price control deliverables should also be used to track the intermediate milestones and outputs/outcomes expected from multi-period schemes which may get funded at PR24, both during the 2025-30 period, and beyond.

6.6 Companies should deliver best value

Companies providing greater public value is a key part of our strategy. One of the three strategic goals in our 2019 Strategy, 'Time to act, together', is 'For water companies to provide greater social and environmental value, **delivering more for customers, society, and the environment**.'

Delivering wider value is also a main theme in the UK government's SPS[110] and is in line with the strategic objectives of the Welsh Government.[111] One of the four strategic priorities in the UK government's SPS is for Ofwat to "challenge the water industry to plan, invest in, and operate its water and wastewater services to secure the needs of current and future customers, in a way which delivers value to customer, the environment and wider society over the long-term". Similarly, one of the strategic objectives of the Welsh Government is for Ofwat to deliver best value solutions by encouraging investment that responds to multiple drivers or has multiple benefits and that takes account of outcomes and the wider environmental and social value of solutions.

We want companies to deliver enhancement schemes which are best value. Best value schemes are those that generate the greatest economic benefit for customers, the environment and society, compared to costs, over the long-term. Best value should take account of factors such as short term and long-term risks, the uncertainties around the costs and benefits of the scheme and the flexibility and adaptability of the scheme to meet future needs. It should also take account of the impact of the scheme on the **affordability** of customers' bills.[112]

Assessing best value requires considering all the potential benefit and cost impacts of a scheme. There can be a wide variety of benefits from schemes beyond that of the primary scheme purpose. These can encompass environmental and biodiversity improvements and social benefits such as public health, wellbeing and recreation. To illustrate this, the creation of a sustainable urban drainage system may not only reduce the use of storm overflows (the primary scheme purpose); it may also reduce flood risk for residents and deliver carbon savings, biodiversity gains and amenity and recreational benefits. These benefits need to be compared against the costs of the scheme to assess the value that the scheme would bring to customers, the environment and society.

We are keen to promote best value as part of PR24. We want to support enhancement schemes that deliver **additional environmental and social benefits which outweigh any additional costs**. Not all schemes that generate additional benefits will necessarily be best value. Schemes where additional costs outweigh the additional benefits will not be best value.[113] Least cost schemes can be best value where alternatives offer smaller net benefits (even if these alternatives are value for money). Therefore, companies need to approach the

[110] Defra, 'The government's strategic priorities for Ofwat', February 2022.
[111] One of the four strategic priorities in the UK government's SPS is for Ofwat to "challenge the water industry to plan, invest in, and operate its water and wastewater services to secure the needs of current and future customers, in a way which delivers value to customer, the environment and wider society over the long-term". Similarly, one of the strategic objectives of the Welsh Government is for Ofwat to deliver best value solutions by encouraging investment that responds to multiple drivers or has multiple benefits and that takes account of outcomes and the wider environmental and social value of solutions.
[112] Further considerations in relation to best value solutions are set out in the WRMP guidelines.
[113] Furthermore, a scheme cannot be "best value" unless it delivers outcomes consistent with companies' legal duties.

assessment of best value with an open mind and should consider a variety of options to identify the best solution for customers, the environment and society.

We expect the additional benefits that most influence the choice of solution need to be **measurable and robustly demonstrated**.[114] Benefits that are not measurable or robustly demonstrated should not be a significant driver of cost. Benefits that are likely to be easier for companies to demonstrate robustly include operational carbon and biodiversity benefits (both of which have common standards and can be tracked through performance commitments). We set out our expectations on how companies should assess best value and evaluate wider benefits in more detail in Appendix 9. Our proposed approach to assessing best value builds on our public value principles.

We also want to **facilitate a greater use of nature-based solutions**. Nature-based solutions can generate additional social and environmental benefits but can have additional operating expenditure. Our current regulatory approach provides less funding surety for schemes which are more reliant on operating expenditure[115], and so may have the unintended consequence of disadvantaging operating expenditure-based nature-based solutions compared to more traditional capital-intensive solutions.

To address this issue, we have considered a solution put forward by companies which proposes to **capitalise the net present value of the whole-life operating expenditure of nature-based solutions** and adding this to the companies' Regulatory Capital Value (RCV). We are supportive of this option if feasible to implement, however there are several challenges that would need to be overcome for this to become a workable solution, such as the risk of double funding as additional operating expenditure will be reflected in our base cost allowances in due course. Alternatively, we are proposing to set a **ten-year operating expenditure allowance** (to be recovered over two price control periods) related to nature-based solutions which are wholly or primarily based on on-going operating expenditure. This should provide companies with additional surety of funding for these types of solutions while not overly increasing the complexity of our regulatory framework.

We are concerned about the impact that additional benefit schemes could have on customer bills. Consistent with our public value principles, companies should seek to create further social and environmental value in the course of delivering their statutory functions. Where companies seek to go beyond what is necessary to meet their statutory requirements, and deliver wider benefits at a greater cost to customers, we will require companies to

[114] This is consistent with the WINEP Options development guidance which states that for the WINEP's wider environmental outcome benefits to be accounted for in the options development process, companies must be able to robustly demonstrate how and when your investments will contribute to the WINEP wider environmental outcomes (see WINEP Options development guidance, p.11). In this context robust means that measurements are not unduly open to bias or manipulation, and that any such influences can be effectively mitigated where they exist. Demonstrability means investment impacts should be observable in a way that can be objectively recorded and reported on.

[115] Operating expenditure for enhancement projects is currently reported as enhancement for a single price control period. It is then reported as base in the next control period, but it is not reflected in the base cost econometric models for another five years since the models are backwards looking.

demonstrate **evidence of customer views**.[116] We also expect companies to ensure that their package of enhancement proposals is affordable to customers and provide evidence to demonstrate this.

As customers may pay more for enhancement schemes which deliver additional benefits, we intend to monitor the delivery of these benefits and for companies to reflect these benefits in performance commitments or price control deliverables where possible. Benefits which are not measurable, verifiable and linked to a performance commitment or price control deliverable should not be a material driver of overall costs and should be reasonably modest.

Delivering wider benefits does not need to be at greater cost to customers. One way this can be achieved is if companies **work in collaboration with others**. Where third parties (eg local authorities, farmers, estate developers, community groups, catchment partnerships) derive material benefits from the scheme, we expect companies to work with these parties and maximise co-funding opportunities where this is efficient to do so. Consistent with our public value principles, we expect these contributions to be in proportion to the benefits that third parties derive from the scheme. We set out our expectations on third-party contributions in more detail in Appendix 9.

6.7 Consultation questions

Providing companies with an efficient cost allowance

Q6.1. Do you agree with our proposed approach to setting efficient expenditure allowances at PR24?

Q6.2. What are your views on how we can best align the treatment of third-party costs and revenues?

Q6.3. Do you agree that companies that submit the most stretching and well evidenced business plans should receive the most favourable cost sharing rates at PR24?

Funding for water companies to maintain good asset health and resilience

Q6.4. Do you agree that resilience enhancement should be used to fund companies to manage increasing risks to specific hazards that are beyond their control and not covered by base expenditure and other enhancement areas?

[116] This is consistent with our public value principles which state that the delivery of social and environmental value outcomes should not come at a greater cost to customers without evidence of customer views. See Ofwat, 'Ofwat's Final Public Value Principles,' March 2022, p. 6.

Delivering service improvements to customers and the environment from expenditure allowances

Q6.5. Do you agree with our proposed approach to setting performance commitment levels at PR24?

Q6.6. Do you agree with our view on what performance commitments should be set using common or company specific performance commitment levels?

Facilitating efficient investment over 2025-30 and the long term

Q6.7. Do you agree with our proposed approach to incentivising and funding efficient investment in reducing greenhouse gas emissions and reducing the use of storm overflows?

Q6.8. Do you agree with our proposed approach to implementing nutrient neutrality in the PR24 regulatory framework?

Delivering best value

Q6.9. Do you agree with our proposed approach to encouraging companies to deliver best value through our cost assessment?

Q6.10. Do you agree with our proposed approach to removing the potential disadvantage that nature-based operating expenditure solutions may face in relation to the treatment of enhancement operating expenditure?

7. Aligning risk and return

7.1 Introduction and summary

In this chapter we discuss the alignment of risk and return, our proposed approach to setting allowed returns and the notional capital structure, the treatment of inflation, our proposals for RCV indexation, and our approach to setting tax allowances.

Our aim for PR24 remains to align the interests of companies and investors with those of customers, so that the sector is attractive to investors, but companies can only earn high returns from great performance.

We have carefully considered the feedback to our December discussion paper[117] and the January workshops[118] and carried out further analysis. Our further analysis on the approach to risk and return is in Appendix 10, and Appendix 11.

We discuss our approach to financeability for the notional capital structure in Chapter 8. In Chapter 9 we set out how we expect companies to demonstrate their business plan allows them to maintain financial resilience in 2025-30 and beyond and our expectations regarding reasonable dividend policies and dividend payments, and performance related executive pay in 2025-30.

Key messages

For PR24 we intend to:

- **provide an early view of the cost of capital in our final methodology**. We expect companies to use this cost of capital in their business plans or provide compelling evidence that another rate is more appropriate.
- **allocate risks to those best placed to manage them,** and **align customer interests with those of companies and investors** through operating a proportionately-sized suite of uncertainty mechanisms and providing clear incentives for companies to deliver on priorities for customers and the environment;
- **require companies to assess and report on risks around their business plan using return on regulatory equity (RoRE).** This will provide insight into the balance of risk and return and strength of incentives proposed in business plans;
- set the allowed **return on equity on the basis of the capital asset pricing model (CAPM) and not index the allowed return on equity**. We are also exploring ways of making our use of the CAPM more consistent with corporate finance theory to derive an

[117] Ofwat, 'PR24 and beyond: Discussion paper on risk and return', December 2021.
[118] Our workshops were in January 2022, including: 20 January workshop; workshop summary; and Financial resilience and PR24 risk and return discussion papers – Investor roundtable (24 January 2022).

allowed return which is less sensitive to the level of notional gearing. We do not envisage departing from the CAPM-derived estimate of the allowed return, unless there is strong and compelling evidence from **market-based cross-checks**;
- recognise that **there may be a case for a stronger role for equity in the notional capital structure** and, therefore, there may be benefits to adopting a lower notional gearing level at PR24. The choice of notional gearing has an important signalling and incentive function, and should reflect the more uncertain environment faced by water and wastewater companies at PR24 and beyond;
- **focus on balance sheet debt** as our primary method for setting an **embedded debt allowance**, excluding swaps and non-standard debt instruments;[119]
- retain our PR19 approach of setting a **separate, indexed, allowance for new debt**. We are considering options around how to make our index-based allowance more aligned with the new debt rates that companies are able to achieve;
- **simplify how we consider requests for company-specific adjustments to the allowed return** by small companies by discontinuing our PR19 customer benefits assessment;
- **fully index the RCV to CPIH** from the start of the 2025-30 control period. This will ensure that water bills are no longer influenced by the discredited and upwardly-biased RPI measure and will allow for a simpler suite of PR24 models;
- set **tax allowances for each wholesale control as if they were stand-alone entities** and to set the **margin for the retail controls to include an allowance for tax**. We propose to retain our PR19 mechanism for passing through significant changes in elements of the tax framework outside company control such as the corporate tax rate and capital allowances.

The chapter is structured as follows:

- **Balance of risk and return** (section 7.2);
- **Our approach to the allowed return** (section 7.3);
- **Our approach to inflation** (section 7.4);
- **Our approach to RCV indexation** (section 7.5);
- **Our approach to the notional capital structure** (section 7.6); and
- **Our approach to corporation tax** (section 7.7).

7.2 Balance of risk and return

In this section we explain how we propose to calibrate the PR24 risk and return package to align the interests of companies with their customers. A key consideration in allocating risks is whether or not companies can manage them, or their impact. If a company shares in the consequences of a risk it can influence, it will have an incentive to manage down the risk's likelihood and impact, which can lead to better outcomes for customers. We seek however to

[119] We also expect that at PR24 the cost of debt will be materially lower than at PR19 as relatively costly embedded debt is replaced by more recently issued debt at lower rates.

limit the exposure of companies to risks (or the consequences of risks) they cannot effectively manage, as this can place upwards pressure on the cost of capital, and hence customer bills.

While we set the allowed return on the basis of the notional capital structure, companies remain responsible for their financing choices, their licence and company law. They must maintain their own financial resilience and we expect companies to meet our expectations regarding the design and application of dividend policies in 2025-30. We set out our expectations on dividend policy in Chapter 9. We require that companies are transparent in their business plans around how dividend policies and dividends paid take account of these expectations, including how they relate to delivery of obligations and commitments to customers and long-term financial resilience.

7.2.1 Managing risk and uncertainty

We propose to continue to protect companies through our suite of reconciliations (as set out in Appendix 13), and our framework for interim determinations. We expect companies to manage the risks (and consequences of risks) they are best-placed to manage, and in the following section set out our expectations around how companies should assess different risk scenarios which could impact on their business plan.

As part of our objective to reduce unnecessary complexity and regulatory burden, we have undertaken a high-level assessment of our reconciliation mechanisms. Taking account of our proposals elsewhere in our methodology, we propose to remove the RPI-CPIH wedge model and the Bilateral Entry Adjustments Model as reconciliation models that are no longer required. A further three models are under review for our final methodology.[120] We intend that there will be a high evidential bar for accepting notified items[121] or bespoke uncertainty mechanisms, as our existing suite of reconciliations already provides for significant risk sharing with customers. There is no automatic presumption that PR19 mechanisms will be rolled forward to PR24. We set out further detail on our policy for uncertainty mechanisms in Appendix 13.

7.2.2 Analysing the balance of incentives

We propose to retain Return on Regulated Equity (RoRE) as the basis for measuring the financial risk companies may face at PR24. We believe that collaborating with the sector to develop RoRE ranges can support two objectives at PR24:

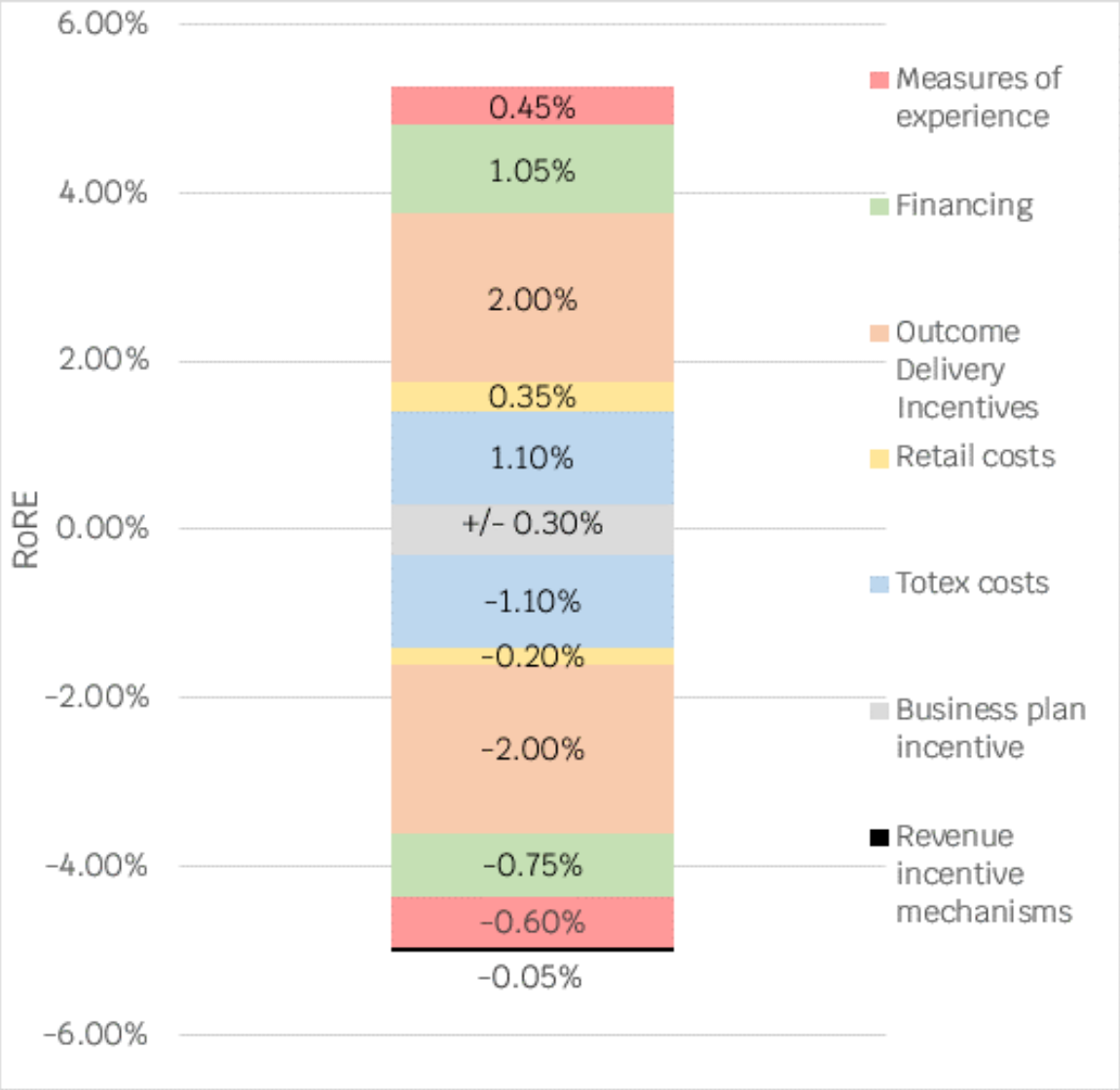
[120] 1) Developer services revenue adjustment mechanism, 2) Water Industry National Environment Programme (WINEP) reconciliation, 3) Gearing outperformance sharing mechanism.
[121] A "notified item" is an item we specify that has not been allowed for (either in full or not at all) in our price control determination. Notified items are (together with the relevant changes of circumstance specified in company licences) eligible for consideration as part of an interim determination.

- Firstly, it can help to **align customer and company interests:** an early view of the relative magnitude of return at risk from different building blocks facilitates company planning to achieve customer priorities.
- Secondly, it can help to **illustrate the risk-reward balance of PR24:** the distribution of risk ranges can provide insight into whether the risk-reward balance of company business plans and our PR24 incentive package is set appropriately.

We propose to require companies to assess and report on risks around their business plan using RoRE. We expect companies to properly consider the scope for upside as well as downside performance, and to explain the assumptions and calculations underpinning their risk ranges. For PR24 we propose to provide more prescriptive guidance to companies than at PR19. This is to improve the comparability and insight of risk analysis. Our draft guidance can be found in Appendix 10.

In addition to that guidance, we are also providing our own preliminary view of the balance of incentives faced by the notional company at PR24. Figure 7.1 sets out our assessment based on historical performance data and our draft PR24 policy proposals; expressed as a range between the 'reasonable downside' (P10) and 'reasonable upside' (P90) over the 5 years of PR24. We consider that, based on our current policy positions, our overall package at PR24 is likely to put at least as much return at risk as at PR19.

Figure 7.1: Indicative PR24 RoRE risk ranges for the notional company[122]



Source: Ofwat analysis of historical company performance data
Note**:** Figures are expressed as variation from the CPIH-real base return.

For simplicity we have presented the overall range as the additive sum of parts, however, we expect the overall range achieved in practice could be narrower due to cross-correlations between certain components.[123] Furthermore, it is also unlikely that a company would experience all P10s or all P90s for the categories in Figure 7.1 in any given control period. We explain the calculations underpinning this figure in Appendix 10.

[122] Measure of experience refers to the three incentives; Customer Measure of Experience (C-MeX), Developer Measure of Experience (D-MeX) and the newly proposed Business Measure of Experience (BR-MeX). Impacts in the chart are shown as an average annualised impact over the 5-year control period.
[123] For instance, a company could overspend on totex to achieve outperformance for Outcome Delivery Incentives.

7.3 Our approach to the allowed return

We propose to set the allowed return on the basis of a weighted average cost of capital (WACC) for wholesale controls and a retail margin for the retail controls. In both cases, we propose to set the allowed return by reference to an efficient company with the notional capital structure.

For retail financing costs we propose to retain an allowance in the form of a net margin on the revenues attributable to residential supply. We will in addition set net margins for business customers of Welsh companies, due to the lack of business retail competition in that market segment.[124] As at PR19, we propose to set a point estimate based on a review of retailer earnings before interest and tax (EBIT) margins and evidence from other sectors. To avoid compensating investors twice for retail risks, we will subtract the retail margin from the appointee-level allowed return to derive a wholesale allowed return which we will apply to the wholesale controls.[125]

We propose to apply the same wholesale allowed return to the following controls:

- Water Network Plus;
- Wastewater Network Plus;
- Water Resources;
- Bioresources.[126]

7.3.1 Wider market context for expected returns

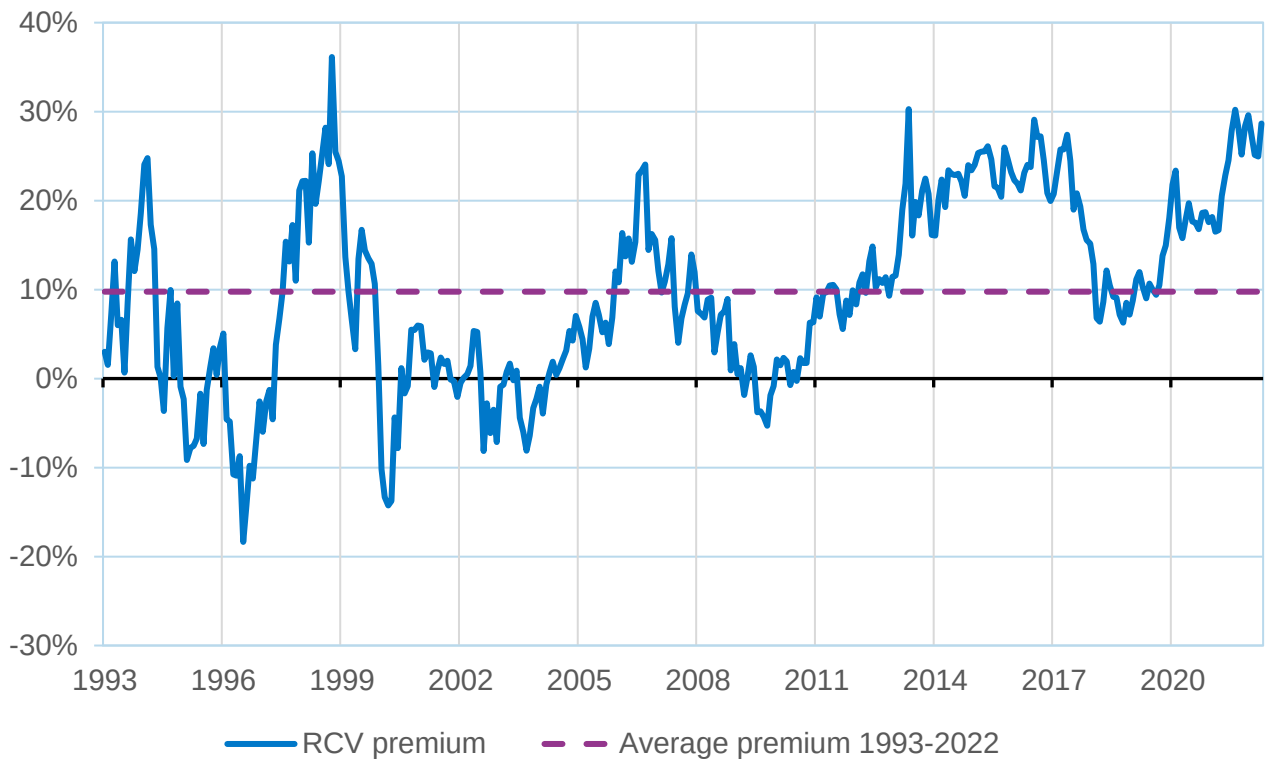
The PR19 price control was carried out against a 'lower for longer' market context characterised by a prolonged period of depressed yields across a range of asset classes and expectations of slow economic growth. In addition to the previously relevant demographic factors[127] which continue to weigh on returns, we now observe factors currently driving high inflation and challenging medium-term growth prospects, such as the continuing effects of Covid-19, and other macroeconomic impacts.

It is too early to take a view on whether these factors will result in an allowed return on equity materially different to that which we set at PR19. Much will depend on the persistence of these factors and their consequences in the run up to PR24 final determinations. However, water stocks have traditionally been viewed as 'safe haven' assets in times of economic

[124] The retail market for business customers of Welsh companies is not open to competition except in relation to supplies of water of at least 50 Ml per year.
[125] The retail margin adjustment is designed to avoid double counting of compensation for retail risks in both the retail margin and appointee allowed return.
[126] We intend to use the PR24 wholesale allowed return for setting allowed bioresources revenues but will reflect it differently for pre-2020 and post-2020 RCV. For further details see Appendix 4.
[127] For instance, an ageing global population with higher savings rates.

turbulence and, as Figure 7.2 suggests, the UK water sector remains highly attractive to equity investors, when considering recent equity valuations against their historical context.[128]

Figure 7.2: Monthly average enterprise value premium to RCV for listed water companies



Source: Ofwat analysis, Bloomberg, equity analyst reports.

We expect that the real cost of debt will be lower than at PR19.[129] To a large extent this is the result of maturing legacy debt being refinanced at lower rates. Our early view of the allowed return in our final methodology will include our updated analysis based on the latest available balance sheet data.

7.3.2 Our approach to the return on equity

Consistent with price controls across the regulated sectors, academic recommendations,[130] and other UK regulatory practice,[131] **we will retain the CAPM as our main tool for cost of equity estimation**. We also propose to **retain a fixed cost of equity rather than index**

[128] This is apparent not only in listed company share prices, but in premia to RCV from private transactions such as the 44% premium in Pennon's 2021 acquisition of Bristol Water.
[129] Moody's forecast in 2021 that the allowed cost of debt could fall from 2.14% to 1.68% (real, CPIH); see Moody's Investors Service (5 October 2021): Companies could face another cut in allowed returns in AMP8', 6 October 2021.
[130] Wright et al. 'Estimating the cost of capital for implementation of price controls by UK Regulators', March 2021 p. 22.
[131] For instance, the CMA's PR19 final determinations endorsed using the CAPM, 'Ofwat price determinations, final report', March 2021, p.33, para 84.

the allowed return. We agree with the analysis by PwC suggesting that equity indexation is unlikely to produce sufficiently clear net gains to make it a priority.[132]

We are exploring ways to **improve the calculation of equity beta** in the CAPM. Where notional gearing differs from the market gearing of listed companies used for raw beta estimation, we adjust the beta to reflect the change in equity risk implied by gearing differences. There are challenges around how to achieve this while staying true to the underlying theory.[133] We propose to pursue a modelling approach in which the debt beta is used to make the forward-looking WACC[134] invariant to gearing. We set out our consideration of options in Appendix 11.

We propose to draw on gilt yields as our primary source of evidence for the risk-free rate. Gilts have a strong claim to be the lowest risk sterling-denominated asset with observable yields. We nonetheless acknowledge the challenge of forming a view on the appropriate RPI-CPIH 'wedge' for the purpose of converting RPI-linked gilt yields to a CPIH basis. In light of the UK Statistics Authority's decision to reform of RPI in February 2030, we consider our PR19 approach of uplifting RPI-linked yields by a long-term RPI-CPI 'wedge' of around one percent to be no longer appropriate, as there should be no long-term difference between the two measures of inflation after 2030.[135] We set out our discussion of options in Appendix 11.

We propose to use long-run equity returns deflated by outturn CPIH and modelled estimates of that series,[136] to derive a plausible range for Total Market Return. At PR19, in line with recent regulatory practice, we derived the equity risk premium (ERP) by subtracting a recent estimate of the risk-free rate from a long-run average of historical equity returns. The underlying assumption that the ERP rises one-for-one to offset falls in the risk-free rate results in ERP estimates that are high by historical standards. We will need to consider further how we should reflect this issue in our future estimation approach. Our preference for using historical CPIH over RPI is due to the difficulties in converting historical RPI-real estimates to a CPIH basis, in light of the UK Statistics Authority's 2030 reform to RPI.

In the absence of strong and compelling evidence to do otherwise, **we propose to use a central estimate from within the CAPM cost of equity range** to set the allowed return. We do not envisage departing from the CAPM-derived central estimate of the allowed return, unless there is strong and compelling evidence from **market-based cross-checks** such as

[132] PWC, 'Cost of equity indexation: Evaluating the case for indexation at PR24 and beyond', October 2021.
[133] In theory, without market frictions and taxes, the cost of capital should be invariant to gearing. This is from the Modigliani-Miller Theorem (see eg Modigliani, F. and Miller, M.H., 'The Cost of Capital, Corporation Finance and the Theory of Investment,' The American Economic Review, 1958.)
[134] That is, a return on capital composed of the expected cost of equity and expected cost of new debt (with no embedded debt allowance).
[135] For example, at the start of 2025 approximately 10 years of the of the 15 years-to-maturity period of 15-years ILGs will be beyond 2030. As a result, in 2025, we expect that the yield of 15-year ILGs would reflect RPI-inflation expectations post-2030 by which time RPI would be equivalent to CPI.
[136] See ONS:, 'Consumer price inflation, historical estimates, UK, 1950 to 1988 – methodology', May 2022.

Market-to-Asset Ratio analysis.[137] We set out our proposed approach to cross-checks in Appendix 11.

7.3.3 Our approach to the return on debt

We propose to set a single sector-level allowance for the cost of debt. We will base this allowance on costs faced by an efficient company at the notional capital structure. Consistent with our PR19 approach, we propose to set a **fixed allowance for embedded debt and to retain indexation of the cost of new debt** by reference to a benchmark index.

In setting an allowance for embedded debt we propose to focus on companies' balance sheet debt. In a sector consisting of many companies we consider that such an approach will better reflect observed debt issuance, while maintaining strong incentives to issue debt efficiently. We propose to use **index-led approaches only as a cross-check** for the upper limit of our allowance.

Our proposed balance sheet approach would **exclude the impact of interest rate swaps.** Including these instruments is unlikely to improve our estimate of debt costs since they are concerned with changing the profile or nature of cash flows, rather than the fundamental cost of raising debt finance. For similar reasons, we would also exclude from consideration instruments whose cost is accounted for in separate allowances (such as issuance and liquidity costs). We set out further details of our approach and rationale in Appendix 11.

We are considering how to share new debt outperformance against our benchmark index. Our analysis of recent new debt issuance suggests a consistent tendency of our unadjusted PR19 benchmark index[138] to overcompensate companies relative to their actually-incurred new debt costs. Our preferred option is to use evidence on water company bonds' average discount to our benchmark index over the control period to apply a fixed adjustment. This could be applied to the outturn yield used to carry out the PR24 end-of period reconciliation. We set out our proposed approach and consideration of the options in Appendix 11.

We propose to set the **share of new debt by reference to the sector's refinancing and new investment needs** and in the context of **potential changes to the notional gearing.** As set out below (section 7.6) there may be benefits to adopting a lower notional gearing level at PR24. If so, we would expect the notional company to retain its prior balance of embedded debt and for gearing reductions to be achieved by a higher share of equity in new financing.

[137] This approach is widely used by equity analysts, institutional investors, central banks, and academics to infer investor discount rates.
[138] The average of the 'A' and 'BBB'-rated iBoxx GBP non-financials 10yr+ indices.

This implies a constraint on new debt volumes, thus we would expect a reduction in notional gearing to reduce the share of new debt in overall borrowings for the notional company.

7.3.4 Company specific adjustments

We propose to streamline the framework by which we would consider any requests by small companies for an uplift to the allowed return on debt. Any such requests should be clearly set out in companies' business plans. We propose to require small companies to clearly justify the level of uplift, as well as providing robust evidence that their customers are willing to fund the bill increase which their proposal implies. Where customer research is used to support a claim, we expect companies to achieve the standards for high quality research if it is to carry weight in our assessment.

Any claimed uplift should only compensate for financing diseconomies of scale at the point of debt issuance, rather than factors more directly under management control (eg timing and tenor). This is consistent with our long-held view that companies and their investors should bear the risks of their choices around financing decisions.

7.4 Our approach to inflation

Previously we used long-term inflation assumptions to convert cost of capital parameters from nominal values into real (RPI) and real (CPIH) price bases.

The current outlook for inflation is uncertain, however we will need to specify an inflation assumption as part of our early view on the allowed return at the end of the year. At this stage, we envisage retaining the Bank of England's 2.0% CPI target as our long-run CPIH assumption where we need a long term forecast for our cost of capital calculations, noting that CPI and CPIH have been very close in value since the CPIH was introduced.[139] We may however revisit this assumption if we consider it is not likely to be a reasonable forecast of inflation.[140]

We set out in section 7.6 that high levels of inflation in the current regulatory period have the effect of reducing gearing levels for the notional company. We will return to these issues in setting the early view of the allowed return in our final methodology.

While the move to full CPIH indexation of the RCV (see below) removes the need to forecast RPI from the perspective of updating the RCV, as noted for our approach to estimating the risk-free rate we will still need to take a view on forecast RPI for the purposes of converting

[139] We provided evidence on the closeness of CPI and CPIH inflation in Ofwat, 'PR24 and beyond: Discussion paper on risk and return', December 2021, Figure 3.2.
[140] We note that the Bank's Monetary Policy committee judged in May that inflation would return close to the 2.0% target in 2 years time. Source: MPC, 'Monetary Policy Report', May 2022, p. 26.

RPI index-linked gilts to a CPIH-equivalent basis using an RPI-CPIH 'wedge'. We set our discussion of options in Appendix 11.

Finally, as for previous determinations, we propose to use shorter term inflation forecasts for the purposes of carrying out our financeability assessment in the financial model.

7.5 Our approach to RCV indexation

The main objective of indexation of the RCV to inflation is to protect the real value of invested capital. In our December discussion paper, we set out that our preferred approach was a transition to full CPIH indexation of the RCV at 1 April 2025. We explained the benefits – particularly around legitimacy, financeability and complexity – but also acknowledged that a faster transition to CPIH indexation would initially place upwards pressure on bills, and that there could be implementation costs.

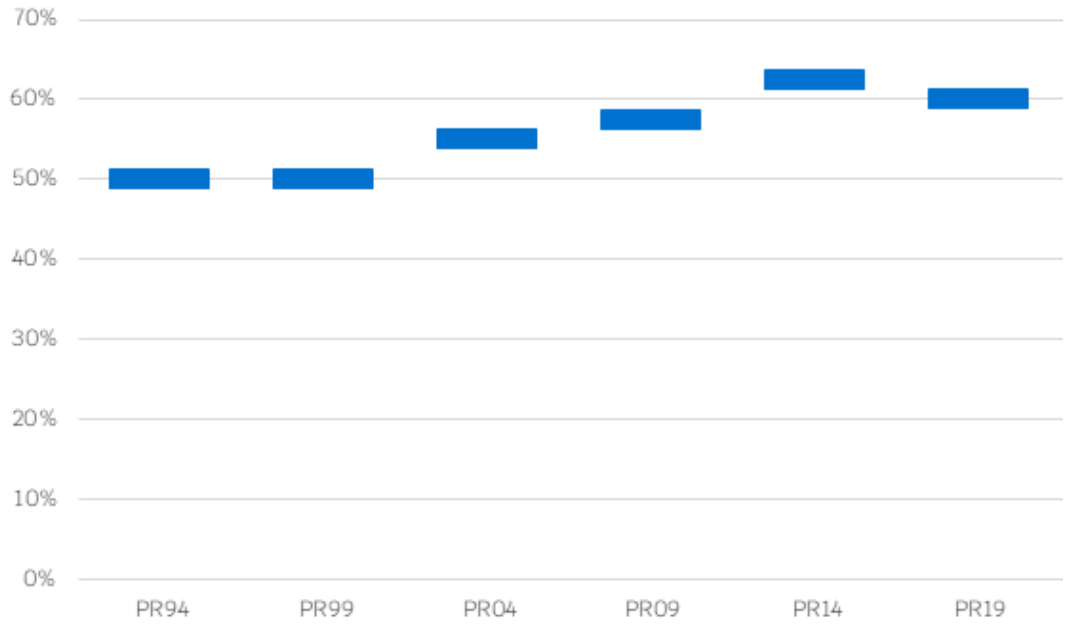
Having conducted a more comprehensive assessment of the potential impact of a full transition to CPIH on nominal bills and given the generally supportive stakeholder responses for CPIH indexation, **our intention remains to fully transition to CPIH indexation from 1 April 2025.** Further detail is set out in Appendix 10.

7.6 Our approach to the notional capital structure

We set our determinations by reference to an efficient company with a notional capital structure. The use of a notional capital structure rather than company-specific data protects customers from bearing much of the risk of companies' actual financing decisions and provides strong incentives to raise finance efficiently. While companies have considerable freedom to deviate from the notional capital structure, they do so at their own risk.

The level of notional gearing acts as an important signalling mechanism to companies considering their own choice of capital structure, because both the allowed return and the financeability assessment are underpinned by an efficient company with the notional level of gearing. Notional gearing set by Ofwat has ranged from 50% to 62.5% between PR94 and PR19. See Figure 7.3.

Figure 7.3: Notional gearing from 1995 to 2025



Source: Ofwat analysis of price review documentation (PR94-PR19)

In our December discussion paper we proposed a framework to determine the appropriate notional capital structure which:

- incentivises efficient financing choices given the **balance of risk faced by water companies**;[141]
- reflects the **scale and nature of investment needs**;
- takes account of a range of **appropriate benchmarks and evidence**; and
- allows the regulator to set a **price control that is in the best interests of current and future customers**.

We will make our decision on the notional capital structure using this framework in our final methodology. At this stage, we remain of the view that **there may be a case for a stronger role for equity in the notional capital structure** and, therefore, there may be benefits to adopting a lower notional gearing level at PR24.

Responses from companies and their investors to the December discussion paper were typically not supportive of a lower notional gearing for PR24, although CCW agreed with the framework that we proposed. Nevertheless, companies providing essential services need a sufficient equity buffer to cope with and recover from the financial impact of supply-side or demand-side shocks. The combined effects of a more uncertain future (for example, driven by less predictable weather and the effects of climate change), levels of financial penalties that have increased over time and revenue at risk from service performance (even

[141] We consider that the notional company should maintain an appropriate level of equity that provides sufficient headroom to reflect the risks faced by the company, and to provide a capital structure that allows efficient access to the debt market through an investment grade credit rating.

accounting for the PR19 reduction in notional gearing) and uncertain ongoing effects of the global pandemic and other macroeconomic impacts, may indicate a greater role for equity at PR24. We set out in further detail our response to the issues raised by stakeholders to our December paper in Appendix 10.

Finally, in the current period of elevated inflation, we would expect the notional company (and most companies under their actual structures) to reduce gearing ahead of PR24 final determinations. This is as, unlike the RCV, the amount repayable for nominal fixed rate debt (and to some extent, floating-rate debt) does not grow in line with inflation. The benefits of high inflation will be felt most keenly by companies with a higher share of fixed and floating-rate debt in their financing structure, as well as the notional company, with its high share of fixed-rate debt.

7.7 Our approach to corporation tax

We calculate a separate tax allowance to ensure the revenue that companies receive covers all relevant expenditure including tax. This is consistent with the basis for setting the allowed return because we use a post-tax cost of equity. Our overall approach to tax aims to incentivise companies to manage their tax affairs efficiently – while recognising that it is important for companies to take responsibility for the tax elements of their plans – and to make sure the approach is fair to customers.

For PR19 we introduced a mechanism to make adjustments to the tax allowance for certain matters that are outside company control such as changes in the corporate tax rate and capital allowances. This ensures that customers pay no more than is implied by prevailing tax rates where tax rates are below our price determination assumptions but would pay more where tax rates turn out to be higher than assumed. We propose to retain this mechanism for PR24.

Consistent with previous price controls, we propose calculating tax allowances on the basis of the gearing that underpins the notional financial structure, or a company's actual gearing if higher. This will ensure that customers, rather than investors, benefit from the higher tax shield from interest payments. Where a company increases gearing as a result of a financial restructuring, we propose to claw back the tax benefits for customers as part of the next price review. This removes the incentive for companies to increase gearing simply to benefit from a lower tax bill.

7.8 Consultation questions

Q7.1. Do you have any comments on our approach to the overall balance of the PR24 incentive package, our proposed guidance on producing risk ranges, and our view of the balance of risk facing the notional company?

Q7.2. Do you agree with our proposals on the regulatory regime for managing companies' exposure to uncertainty over 2025-30?

Q7.3. Is there value in introducing more prescriptive requirements and guidance for company-produced RoRE risk ranges? How might this be implemented for:

a. Interactions between performance on cost and service?

b. Interactions between performance on different ODIs?

Q7.4. Do you agree with our proposed approach to setting the allowed return on equity?

Q7.5. Do you agree with our proposed approach to setting the allowed return on debt?

Q7.6. What are your views on the options we have set out for estimating the RPI-CPIH wedge for converting RPI-linked yields to a CPIH basis?

Q7.7. Do you agree with our proposed approach to the notional structure and setting allowances for corporation tax?

8. Aligning risk and return: Financeability

8.1 Introduction and summary

This chapter sets out our proposals on the **assessment of financeability** and **cost recovery**. Our proposed approach is designed to ensure that revenues, relative to allowed costs, are sufficient for an efficient company with the notional capital structure to finance its investment on reasonable terms, while protecting the interests of customers now and in the long term.

Each company will need to submit a plan that is financeable and provide Board assurance that it is **financeable on the basis of the notional capital structure**. Each company will need to propose **cost recovery rates** (pay as you go (PAYG) and RCV run-off) consistent with our guidance, in particular, having regard to **balancing the recovery of costs between different generations of customers**.

Key messages

- The financeability assessment is a test of the sufficiency of cashflows from the price control package as a whole. It allows us to assess whether the determination provides sufficient cash flows to service debt interest and repayments for a company with the notional capital structure for the period of the price control.
- Within the boundaries set by the regulatory and licence framework, the choice of actual capital structure and financing is a matter for companies and their shareholders. If financeability constraints arise from these company choices, customers must not bear the costs of resolving them. We discuss our proposed approach to financial resilience in Chapter 9.
- **Each company will need to submit a plan that is financeable** and provide board assurance that it is financeable on the basis of the **notional capital structure**. We propose to assess financeability at the **appointee level by reference to an efficient company with the notional capital structure** that underpins the allowed return on capital, and by reference to a **suite of cash flow financial metrics.**
- Companies should propose **PAYG** and **RCV run-off rates** that balance the recovery of costs between different generations of customers. Companies should set base RCV run-off rates within the **narrow band for RCV run-off rates** that we intend to set out in the final methodology. Companies should provide **evidence setting out how they have determined the rates** for each of the wholesale price controls. Companies should provide compelling rationale in business plans where they depart from the guidance we set out.
- Companies should **target a credit rating of at least two notches above minimum investment grade** in their assessment of financeability of the notional company (BBB+/Baa1).

- Companies have a number of options to address financeability constraints that arise under the notional capital structure. We consider that **equity has an important role to play in funding real RCV growth** such that notional gearing does not increase materially from the opening level. We will look for **evidence of customer views** where companies take steps to address financeability constraints through the reprofiling of cash flows between price review periods.

In the remainder of this chapter we set out our proposals for:

- our approach to **assessing financeability** (section 8.2);
- **cost recovery** for the wholesale controls (section 8.3);
- **target credit ratings** and **proposed financial metrics** underpinning the financeability assessment (section 8.4); and
- **addressing financeability constraints** arising on the notional capital structure (section 8.5).

8.2 Approach to assessing financeability

Our financeability assessment considers whether, when all of the individual components of our determination are taken together (including allowed costs, allowed return, retail margin, PAYG rates and RCV run-off), an efficient company with the notional capital structure will be able to generate cashflows sufficient to meet its financing needs.

We propose that each company should provide board assurance that its plan is financeable on the basis of the notional capital structure. This assurance should take account of all components of the business plan, including our early view on the allowed return on capital for PR24 that we intend to set out in our final methodology. The board statements need to set out clearly the steps taken to provide assurance, including the consideration of the financial ratios listed in section 8.4 below. We discuss financial resilience of the actual capital structure in Chapter 9.

The overall approach to assessing financeability in our determinations will be broadly consistent with the approach adopted in previous determinations. We assess financeability by reference to an efficient company with the notional capital structure that underpins the cost of capital, and before taking account of the revenue impact of any adjustments relating to the previous price review periods (for example, from reconciliation mechanisms).[142]

We propose to carry out our financeability assessment in our financial model which companies will be required to complete as part of their business plan submissions. Gearing in

[142] Reconciliation adjustments to revenue in the draft and final determination are excluded before considering financeability to ensure incentives for companies are not diluted and customers do not compensate companies for prior poor performance. However, midnight adjustments (ie those made at the inception of the control period) to RCV do form part of the assessment.

the financial model is set at the notional level at the beginning of the price review period and may vary thereafter. We propose to assume a proportion of index linked debt in the opening balance sheet. Our decision on the proportion will be informed by the level of issuance across the sector. We propose that over the price control period, new debt will be raised by a proportion of CPI linked debt and fixed rate debt. We will also set an assumption for dividends in the financial model for the purposes of assessing financeability of the notional company. As for previous price reviews, we propose to set a dividend yield and growth assumption based on the allowed return on equity.[143]

We consider that where there is significant investment in 2025 to 2030, this should be financed by a mixture of debt and equity. Therefore, we expect companies to propose adjustments to dividends and, where necessary, to provide for new equity within the financial model where gearing strays significantly from the notional level because of substantial real RCV growth. In our assessment of financeability for the determinations, we may adjust the dividend yield in such cases. However, in consideration of the role of dividends in equity financeability, we are minded to maintain a reasonable minimum level of dividend yield in the financial model irrespective of the level of real RCV growth and, therefore, assume that additional equity financing comes in the form of new equity where RCV growth is significant. We may provide companies with an allowance for equity issuance costs in such cases.[144]

8.3 Cost recovery for wholesale controls

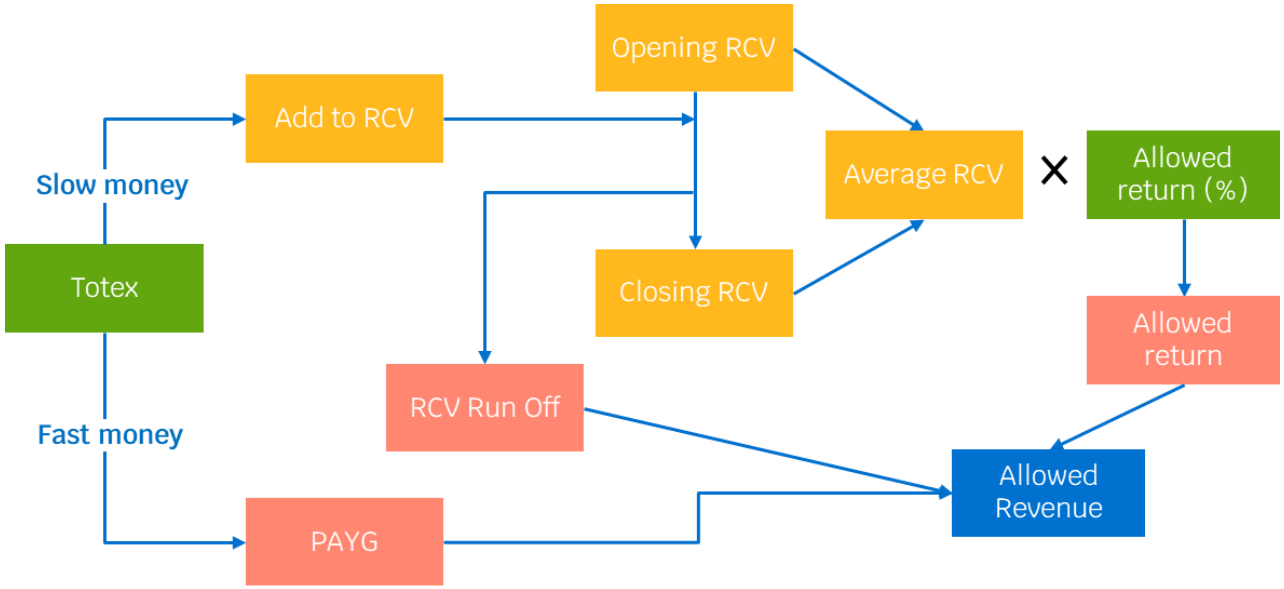
Our totex allowances for wholesale controls ensure that each company can recover its efficient costs over time to enable it to deliver its commitments to customers, communities and the environment.

Annual totex allowances are recovered through allowed revenue in one of two ways. They can be recovered in the period incurred through PAYG or can be added to the RCV and recovered over a longer period through the RCV run-off (amortisation of the RCV) as shown in Figure 8.1.

We are proposing to set our revenue control for bioresources as an average revenue control to support the bioresources market as set out in Chapter 3 and Appendix 4. Companies will recover their efficient costs based on the amount of sludge produced. For the purposes of our financeability assessment, we propose to assume that companies receive revenue in line with forecast volumes and that new investment not recovered through the average revenue control will be recognised as 'post 2025 RCV'.

[143] At PR19, the dividend yield was calculated based on the average payout ratio of European stocks. We assumed that the dividend yield grew by CPIH inflation of 2.0% plus the difference between the yield and the real CPIH based cost of equity.
[144] Ofgem's recent RIIO-2 determinations included a 5 basis points allowance for issuance costs for new equity. We applied a similar allowance at PR09.

Figure 8.1 Regulatory building blocks and cost recovery



- PAYG represents totex expensed in the year
- Totex not expensed is added to the RCV
- Each control has a separate RCV
- The return on RCV compensates for the investment that is in the RCV
- RCV run-off represents the amortisation of RCV

PAYG and RCV run-off rates set the speed at which companies receive the revenue which balances recovery of costs between different generations of customers.

If cost recovery is too slow, companies may have insufficient resources to finance their operations and maintain the capability of their assets. Future customers may also end up paying too much for their services. If cost recovery is too fast current customers may be paying too much. If this persists over the long-term, companies are likely to deplete their RCV which may lead to financeability constraints in the future. Neither scenario protects the interests of customers over the long-term.

At PR19 (and PR14), companies proposed RCV run-off rates in business plans for each wholesale control which were largely used in our final determinations. At PR19, average annual RCV run-off rates for the water companies at final determinations ranged from 3.7% to 7.1%. 7.1% equates to approximately 30% of opening RCV being recovered from current customers in the control period.[145] If sustained, this could result in a significant real terms reduction to the RCV over price review periods, with potential detrimental impacts to the ability of a company to withstand cost shocks and maintain financial resilience.

[145] Annual amortisation of RCV at 7.1% per annum results in 69.2% of opening RCV remaining after 5 years ($(1-0.071)^5$).

Typically, over the longer term we would expect the amount of revenue generated from customers in respect of the RCV run-off to be close to that required to be reinvested in new or replacement regulatory assets. But where it is not reinvested in the growth of the asset base, this revenue can be considered to be a return of capital to investors. Analysis of RCV run-off in PR19 final determinations and proposed non-enhancement capital expenditure (which is required to maintain the long-term capability of the assets – as reflected in base totex submissions in business plans), showed that, in almost all cases, the planned spend was less than the total cost recovery in the PR19 price review period. We set out our analysis in Appendix 10.

At PR24, we are minded to set a narrow range for RCV run-off rates for each wholesale control that we consider represents a reasonable balance of cost recovery between current and future customers. We consider this range is best informed by a consideration of average remaining lives of the assets utilised in each control to provide the services to customers, while ensuring that companies have sufficient resources to maintain the capability of their assets. The remaining asset lives can be thought of as a fair period over which to amortise the remaining RCV balance for each generation of customers. We will provide this range in the final methodology.

We expect companies to provide evidence setting out how they have identified the levels for PAYG rates for each of the wholesale price controls and for RCV run-off rates within our narrow band. If companies propose different RCV run-off rates for existing RCV and new investment, they should provide sufficient and convincing evidence to support each rate. Such evidence might include comparisons against costs incurred in the past and expectations based on the cost and investment profile in 2025-30, including the split of operating and capital expenditure. Companies may propose adjustments to PAYG and/or RCV run-off rates that defer or accelerate cost recovery, for example to address a financeability constraint or to profile bills. Where companies propose adjustments to PAYG and/or RCV run-off rates to adjust cash flows between price review periods, we expect them to explain clearly in their business plans the reasons for this. Where companies propose to bring forward revenue in this way, we would expect the business plan to set out clearly how the company intends to use the additional revenue.

As set out in Chapter 6, we are supportive of an option put forward by companies that would allow nature-based solutions that are predominantly on-going operating expenditure to be treated as investments that can be added to the RCV, subject to addressing challenges to deliver a workable solution. Where a company proposes such an option in its business plan, we expect it to set out clearly the possible impacts on the financeability of the notional structure and to confirm the effects of the proposal can be managed under the actual capital structure.

Companies will need to provide evidence that they have considered the impact of their proposals on customers both now and in the longer term and they should provide evidence of

customer views on the chosen bill profile incorporating the PAYG and RCV run-off proposals.[146]

8.4 Target credit ratings and proposed financial metrics

Financeability is an 'in the round' assessment taking account of a range of financial metrics and other factors that may be relevant to the assessment. Companies are responsible for submitting a plan that is financeable which should include targeting a robust credit rating comfortably above the minimum requirements of the licence. At PR19, our determinations were set on the basis of the notional company with a credit rating two notches above the minimum investment grade (BBB+/Baa1), and we consider this continues to provide a reasonable level of headroom to allow companies to cope with most cost shocks. This is a level we consider appropriate for an efficient company providing essential services over the long term. Therefore, for PR24 business plans, we propose that companies target credit ratings of at least BBB+/Baa1 for the notional company. Companies should specify the level of each financial ratio they consider appropriate for the target credit rating.

We expect to use the aggregated revenues, costs and cash flows across each of the price controls and we will look for each company's projected financial ratios to be at levels which allow it to finance its functions. The financial metrics we propose to use to assess financeability are incorporated in the draft version of the PR24 financial model. Table 8.1 shows the ratios we collect annually from companies in annual performance reports which we expect to form the basket of metrics considered in our assessment of financeability. We propose to place most weight on the key measures of indebtedness and the ability to service and repay debt which are gearing, adjusted interest cover and funds from operations to net debt ratios.

Table 8.1: Financial metrics

Financial metric	Basis of calculation	What does the metric calculate?
Gearing	$\frac{\text{Net debt}}{\text{RCV}}$	Gearing measures a company's capital structure and level of indebtedness
Interest cover	$\frac{\text{FFO (pre interest)}}{\text{Cash interest}}$	Interest cover measures a company's ability to meet interest payments from operational cash flows.
Adjusted cash interest cover ratio (ACICR)	$\frac{\text{FFO (pre interest)} - \text{RCV run off}}{\text{Cash interest}}$	ACICR is a more conservative measure than interest cover. It provides an indication of interest coverage assuming companies cannot reduce the RCV run-off.
Adjusted cash interest cover	$\frac{\text{FFO (pre interest)} - \text{RCV run off} - \text{Surplus PAYG revenue}}{\text{Cash interest}}$	The alternative ACICR removes any surplus PAYG revenue over operating expenses in calculating

[146] Where specific customer research is being done, we expect companies to achieve the standards for high quality research. See standards for high quality research.

ratio (ACICR) – alternative measure		interest coverage. It assumes that surplus PAYG improves in-period cash flows without improving credit worthiness.
Funds from operations (FFO) / Net debt	$\frac{\text{FFO (post interest)}}{\text{Net debt}}$	FFO/Net debt measures a company's debt burden relative to their operational income.
Funds from operations (FFO) / Net debt – alternative measure	$\frac{\text{FFO (post interest including accretion of index linked debt)}}{\text{Net debt}}$	The alternative version of FFO/Net debt recognises the full interest charge for interest linked debt (rather than the cash interest charge in the standard version).
Dividend cover	$\frac{\text{Profit after tax}}{\text{Dividends declared}}$	Dividend cover measures a company's capacity to pay dividends at current levels. Profit after tax is defined as funds from operations (post interest) less tax charge.
Retained cash flow (RCF)/Net Debt	$\frac{\text{FFO(post interest)} - \text{dividends paid}}{\text{Net debt}}$	RCF/Net debt measures a company's debt burden relative to their operational income after paying interest and dividends.
Return on capital employed (RoCE)	$\frac{\text{EBIT} - \text{tax}}{\text{RCV}}$	RoCE can be compared against the allowed return on capital. It presents the returns made by the providers of both debt and equity finance.
Return on regulatory equity (RoRE)	$\frac{\text{EBIT} - \text{tax} - (\text{cost of debt} * \text{net debt})}{\text{equity component of the RCV}}$	RoRE measures the return due to shareholders/equity assumed in the notional capital structure. It allows us to assess the returns earned by equity providers against the allowed return on equity.

Notes: Net debt represents borrowings less cash and excludes any pension deficit liabilities.
Funds from operations (FFO) is cash flow from operational activities and excludes movements in working capital.
Cash interest excludes the indexation of index-linked debt.

These ratios draw on common approaches used in financial markets and include metrics broadly consistent with those used by the credit rating agencies. The financial ratios used for the assessment of financeability are not designed to precisely replicate rating agency definitions as we are aware that each credit rating agency has its own definition of these financial metrics.[147] However, in recognition of the role played by credit rating agencies when companies access debt markets, we propose to also consider alternative versions of adjusted interest cover and FFO/net debt in our assessment of financeability. The adjustments broadly replicate the adjustments credit rating agencies make.[148]

We expect companies to provide commentary explaining how their plans are financeable on the basis of these metrics and any other factors they consider relevant, both qualitative and

[147] Each credit rating agency has its own definitions for each of its key financial metrics and may make specific adjustments in its assessment of individual company's performance.
[148] The alternative version of adjusted interest cover ratio deducts any surplus pay-as-you-go revenue over operating expenses from funds from operations, broadly recognising the adjustment made by Moody's and Fitch to reflect that such adjustments could improve in-period cash flows. The adjusted FFO/net debt ratio includes the accretion of index-linked debt in the calculation of post interest funds from operations, broadly recognising the adjustment made by S&P.

quantitative. We propose to consider the average of each metric over the price control period. We will also look at trends over the price control period, rather than focusing on individual metrics in a single year.

We expect companies to provide board assurance that the business plan is consistent with maintaining the target credit rating on the basis of the notional capital structure. We expect companies to provide evidence of the steps taken by their board in giving that assurance.

8.5 Addressing financeability constraints

Where a company addresses a financeability constraint that arises under the notional financial structure, we expect its business plan to show that:

- the underlying cause of the constraint has been identified;
- all appropriate factors have been taken into account when deciding how best to mitigate those constraints; and
- the approach to addressing the constraint is appropriate, taking account of the effects on customers' bills.

There is a range of options and market mechanisms available to companies to address financeability constraints where they arise from the notional financial structure. The nature of the financeability constraint may determine the most appropriate mechanism to use.

As set out in section 7.6 above, we will set out our decision for the level of notional gearing in the final methodology and this is applied in the financial model at the start of the period. Where there is significant investment at PR24, gearing may increase materially above the notional level and may lead to a financeability constraint. In such cases, our proposal is that companies use equity solutions to keep gearing broadly consistent with the notional gearing level across the period. Additional equity may be in the form of retained earnings and, if required, further capital raising.

In our assessment of financeability for the determinations, we may adjust the dividend yield to solve a financeability constraint arising due to real RCV growth. As set out in section 8.2, we are minded to maintain a reasonable minimum level of dividend yield in the financial model and, therefore, we may apply additional equity financing in tranches where RCV growth is significant.

As we explain in Chapter 9, companies will need to provide board assurance that the plan is financially resilient based on the actual capital structure. Where a company expects a financeability constraint that could affect its ability to maintain its target credit rating to arise based on its actual company structure, but not the notional structure, it will need to give separate consideration to how it will address the constraint and provide the necessary assurances about its approach.

8.6 Consultation questions

Q8.1. Do you agree with our approach to assessing financeability?

Q8.2. Do you agree with the focus on the metrics outlined in section 8.4 for the assessment of financeability?

Q8.3. Do you agree with our proposed approach to cost recovery, in particular that we set a narrow range for RCV run-off rates within which companies will be required to evidence their choice of rate which best achieves a fair balance between current and future customers?

Q8.4. Do you agree with our proposed approach to resolving a financeability constraint?

9. Promoting financial resilience

9.1 Introduction and summary

The focus of Chapters 7 and 8 is on the basis on which we set price controls – ie the notional company. This chapter is concerned with the financial resilience of actual companies, and the confidence we can have that companies have taken account of customers' interests in financial matters.

Companies are best placed to make decisions over their financing and capital structure arrangements within the boundaries set by the price determination, their licence and company law. Therefore, investors should bear the risks and consequences of those company decisions. It is important for any company that provides essential services to be able to demonstrate its financial resilience and the management of financial risks for the actual capital structure. Therefore, we expect companies to provide **board assurance that their business plans are set in the context of allowing them to maintain financial resilience over 2025 to 2030 and beyond**.

In a sector that provides an essential public service, companies must demonstrate how the decisions they make in declaring and paying dividends and executive performance related pay take account of matters that include meeting obligations and delivery for customers, communities and the environment. Therefore, we expect companies to set out how **dividend and performance related executive pay policies for 2025-30** show alignment between returns to owners and performance related executive pay and what is delivered for customers, society and the environment.

We also want companies to come forward to **promise their customers a fair share of outperformance**, particularly where, for example, companies outperform areas of the price control package that may not be currently subject to sharing mechanisms (for example, because of outperformance of the cost of debt, high inflation, possible taxation gains or miscalibration of the price determination package).

Key messages

- Each company should provide a **board assurance statement** that the actual company is financially resilient over the period of the price review and beyond under its business plan. We expect the statement to set out the steps the board has taken to enable it to make that statement, the factors it has taken account of, and the suite of financial metrics used to ensure the company is financially resilient. We expect the plan to demonstrate the basis on which the assessment has been carried out, including how the base case and downside scenarios have been established and assessed.

- It is for the board of each company **to identify, assess and manage the principal risks relevant to that company**. We expect companies to draw on these risks to develop scenarios (including combined scenarios) to stress test their business plans when assessing financial resilience. Companies should explain any proposed mitigation measures. We expect the board to consider the risks associated with any potential variance from its business plan. Alongside this we propose to specify a **minimum suite of scenarios that we expect companies to consider and to stress test.**
- We are concerned that more needs to be done to protect customers from the risks relating to the companies' actual financial arrangements. Our ambition is that these protections will be achieved through **strengthened ring-fencing provisions** in the licence and through regular company monitoring. We will shortly bring forward proposals to do this. However, we may apply an incentive-based mechanism within the price review if we are not satisfied with progress achieved through other means.
- We expect companies to set out their **proposed dividend policies** for the period 2025-30. We expect companies to be transparent about how dividend policies and dividends paid take account of the guidance we have issued, including that dividends declared or paid take account of company performance in delivering obligations and commitments to customers, communities and the environment, and long term financial resilience.
- We expect companies to set out their **proposed policies for performance-related executive pay**. We expect policies to demonstrate clearly a substantial link to stretching performance delivery for customers, communities and the environment.

The chapter is structured as follows:

- Board assurance of business plans (section 9.2);
- Stress testing business plans (section 9.3);
- Incentivising resilient capital structures (section 9.4);
- Expectations on dividends (section 9.5);
- Expectations on performance related executive pay (section 9.6); and
- Voluntary sharing of outperformance (section 9.7)

9.2 Board assurance of business plans

We define financial resilience as the extent to which an organisation's financial arrangements enable it to avoid, cope with and recover from disruption, whether that disruption is driven internally or externally to the company.

Company boards are responsible for ensuring their company is financially resilient over the price review period and beyond. It is important that companies can demonstrate this in their business plans. Where a company considers there is a risk to financial resilience, the business plan should set out the action the company plans to take to address this. Therefore, we expect business plans to include a board statement that provides us with assurance that

the company will be able to access finance based on the actual capital structure, and that the company remains financially resilient over the long term.

We expect the statement to set out clearly the steps the board has taken in order to give its assurance that the company will remain financially resilient under its business plan. The statement should set out the factors considered within the assessment, both quantitative and qualitative. Where appropriate, the company should set out any mitigating measures it proposes to take to strengthen its financial resilience.

Companies should set out the credit ratings targeted for the actual company in their business plans. Where the target credit rating for the actual company differs from that targeted for the notional company structure, we propose that the board assurance statement explains and provides evidence as to why this is appropriate and in the best interests of customers and the environment.

To support the board assurance statement, companies should set out the key financial ratios for the company assuming it performs in line with its business plan for the actual capital structure and explain how these financial ratios relate to its target credit rating. Business plan tables require companies to populate information about the financial projections for their actual capital structure based on their own assessment and financial projections.

Companies will be expected to demonstrate in their business plans how they will, under a range of potential downside scenarios, continue to finance their operations and planned investments. Companies should explain the steps they intend to take to maintain financial resilience for the duration of the price control and beyond. We set out the proposal for stress testing below.

Company boards should also determine the level of assurance required within the business plan to support the statement that the company is financially resilient. The business plans should set out the level of assurance obtained and explain why the board considered the level appropriate, taking account of issues it considers relevant.

9.3 Stress testing business plans

Each company should be able to demonstrate that its actual capital structure provides sufficient headroom to enable it to continue to deliver its commitments under a range of stressed conditions.

Companies' business plans should provide their assumptions including the financial ratios relevant to the target credit ratings and to any covenants in place. We expect companies to include their assumptions for totex and the revenue allowance, and to consider other costs and parameters included in their business plan such as interest costs. The base case should be clear and take account of the actual company structure. It should include explanations as

to how investment programmes will be financed and show the impact of the investment programme on financial protections. For example, it might reasonably be expected that equity has a role to play in financing material RCV growth especially where a company has a weak financial resilience position. Further to this, companies should explain how the board assured itself that this is the correct base position for the company, based on its specific financing requirements.

We expect companies to assess the scenarios that we prescribe, and to model their own scenarios. Companies will need to explain their decisions drawing links to the company's long term viability statement. The company should clearly state the proposed mitigations that may be undertaken to address any financial resilience constraint it identifies.

Alongside the company specific scenarios, we propose the following common scenarios that companies should model:

- Totex underperformance (10% of totex) over 5 years.
- ODI underperformance payment (3% of RORE) in one year applied in year 2.
- Inflation below the average of independent forecasts for the UK economy as published by HM Treasury (2% below). This scenario should be applied at 2% below in each year of the price review period.
- Deflation of -1% for 2 years, followed by a return to the long term inflation target. The deflation should be in years 1 and 2 to allow time for the return to the long-term inflation target.
- Inflation above the average of independent forecasts for the UK economy as published by HM Treasury (a 10% spike in inflation with a 2% increase in wedge between RPI and CPIH, followed by two years at 5% and a 1% increase in wedge).
- Increase in the level of bad debt (20%) over current bad debt levels applied in years 2 and 3.
- Debt refinanced as it matures, with new debt financed at 2% above the forward projections of interest rates.
- Financial penalty – equivalent to 6% of one year of Appointee turnover applied in year 2.

At PR19 some companies carried out reverse stress testing to demonstrate headroom within their structures. Drawing on this, the business plan tables require companies to determine the level of headroom within their financing arrangements and set out the level of that headroom that is eroded in each of the downside scenarios.

As set out in Section 7.6, periods of high inflation are likely to have a positive impact on the financial resilience of most companies as it provides scope for companies to reduce gearing. However, there may be circumstances where high inflation has a negative impact on financial resilience, for example if a company has a significant amount of RPI linked debt, layered onto a cost base that may increase faster than CPIH. Therefore, we have prescribed a common scenario for higher inflation.

We also expect companies to model appropriate combined scenarios to take account of likely combinations of their specific risk factors. Companies should set out the stresses applied to each of these factors, and why they consider these levels represent severe, reasonable and plausible scenarios.

Where the results of a scenario indicate that the company's finances will not be resilient, we expect companies to set out clearly the mitigations they will take to address that situation, together with supporting evidence (for example, the level of evidence underpinning the commitment of investors if the mitigation includes the injection of equity) or set out sufficient and convincing evidence as to why the scenario will not arise if they consider that is the case.

It is possible that a company's view of the reasonable revenue and cost allowances differs from those that we might consider reasonable for an efficient company. In the business plan submission, companies should set out the possible impacts on their financial resilience of such plausible differences, the consequences thereof and the likely mitigation measures in the event that our view of efficient final determination allowances differ from those requested in business plans.

The common scenarios we set out are not intended to be an exhaustive list. Where appropriate, companies' specific scenarios may need to go beyond this. Companies should also propose scenarios which combine their specific risks. In building combinations of scenarios, companies should consider how the scenario may develop over time and the dependencies between individual factors.

We expect companies to explain the impact of the stress tests on their ability to maintain financial metrics, their credit rating, and their ability to service debt. We also expect companies to explain management's plans to address any concerns arising from the stress testing, including any plans to raise additional debt or equity.

We propose that the extent to which a company is able to demonstrate (through its board assurance statement and supporting information) that it will (a) maintain long-term financial resilience and (b) has appropriate mitigating actions under the range of scenarios presented, will form part of the minimum requirements for business plan incentives (see Chapter 11).

9.4 Incentivising resilient capital structures

We set out the importance of financial resilience and our concerns with respect to companies' financial structures in 'Financial resilience in the water sector: a discussion paper' in December 2021. We are carrying forward work on the options to strengthen the regulatory protections from risky financial structures and we will set out our proposals under a separate consultation to be published over the summer.

We consider the proposals to strengthen the regulatory ring-fence and to enhance monitoring and reporting could serve to increase levels of financial headroom and better protect the interests of customers. This may remove the need for specific incentives at PR24 to encourage companies to adopt more resilient financial structures. However, we may apply an incentive-based mechanism within the price review if we are not satisfied with progress in strengthening the regulatory protections, or in circumstances where companies with risky structures are not delivering tangible improvements in financial resilience. We will return to this in the final methodology taking account of responses to our separate consultation.

9.5 Expectations on dividends

It is important that investors in the water sector can achieve a reasonable return on their invested capital, and dividends are an important part of the equity return. However, it is also important that companies explain their dividend policies and dividends paid. Companies need to be transparent about how these take account of issues set out in our previously published guidance, including delivery of obligations and commitments to customers, communities and the environment, and long term financial resilience.[149] We set out our proposed expectations for dividend polices covering 2025-30 in full in Appendix 10.

We consider it important that companies are able to demonstrate that they remain committed to meeting our expectations for a reasonable dividend and so we expect companies to set out their proposed dividend policy for the period 2025-30 in their business plans.

We will publish a consultation shortly that sets out our proposals to strengthen the regulatory protections with respect to companies' financial structures, which will include considerations in respect of dividends. We see no reason at this point to amend the expectations for a reasonable dividend policy that were set at PR19. However, we have noted that benefits that accrue to equity from the consequences of high inflation (for example where fixed rate debt is in place) are not linked to operational performance. As such these benefits should be retained or reinvested and not distributed as outperformance if companies are to meet our expectations.[150]

Our expectations set out that a base dividend yield of up to 4% is reasonable for companies that have little real RCV growth and that perform in line with their determinations for 2020-25. We intend to review the reasonable base dividend yield to account for the PR24 equity return and set this out alongside our early view of the allowed return in the final methodology.

[149] We set out our expectations for dividend policies in Ofwat, 'PR19 final determinations: Aligning risk and return technical appendix', pp. 117-120, section 9.1.4.
[150] Ofwat, 'PR19 final determinations: Aligning risk and return technical appendix', December 2019, pp. 117-120, section 9.1.4.

As set out in Chapter 11, we propose assessing the dividend policies proposed by companies as part of the quality assessment of minimum expectations for the business plan incentive.

9.6 Expectations on performance related executive pay

Executive pay is a matter for each company. However, the public service nature of the water sector means that companies should be transparent about performance related executive pay and how it takes account of delivery for customers, communities and the environment. Transparency of the relationship between pay and performance helps other stakeholders see how performance related executive pay is aligned to the provision of an essential service.

Companies should set out their policies for performance related executive pay in their business plans. We expect policies to demonstrate that the criteria for awarding short and long-term performance related elements are substantially linked to stretching delivery for customers, which includes environmental commitments and obligations. Where directors' responsibilities are substantially focused on the regulated company and they receive remuneration for these responsibilities from elsewhere in the group, policies relating to this pay should be fully disclosed at the regulated company level. These expectations are in line with our Board leadership, transparency and governance principles.

We expect that performance targets used to determine performance related executive pay are stretching by reference to business plans. However, there should be a commitment to update stretching performance to reflect final determinations. Companies should set out how their remuneration committees ensure there is on-going rigorous challenge as to how the policies are applied, that targets remain appropriate and stretching in the period 2025-30 and to ensure that only truly stretching performance is rewarded. We also set out these expectations at PR19.[151]

We expect policies for performance related executive pay set out in business plans to take account of the letter to the Chairs of Remuneration Committees from the Ofwat Chief Executive in February 2022.[152] The letter set out that we would expect to see clear evidence that pay outcomes should not reward poor performance as a matter of course – for example, that remuneration committees have discretion to recognise shortfalls that become apparent during the year, whatever the initial framework for incentives. We set out our expectations for performance related executive pay policies for the period 2025-30 in Appendix 10.

[151] Ofwat, 'PR19 final determinations: Aligning risk and return technical appendix', December 2019, p. 124, section 9.2.4.
[152] Ofwat, 'Letter from David Black to Chairs of Remuneration Committees – Performance related executive pay for 2021-22', February 2022.

As set out in Chapter 11, we will assess the performance related executive pay policies proposed by companies as part of the quality assessment of minimum expectations for the business plan incentive.

9.7 Voluntary sharing of outperformance

Many areas of the price control package are subject to incentive mechanisms (for example totex and performance commitments) such that investors and customers are aligned. However, there are other areas of the price setting process that may not be subject to sharing mechanisms and where companies and their investors could benefit, for example, because of outperformance of the cost of debt, high inflation, possible taxation gains not covered by reconciliation mechanisms or miscalibration of the price determination package. Therefore, we encourage companies to come forward to promise to share such outperformance with customers on a voluntary basis.

At PR19, a number of companies proposed arrangements that were referenced in our final determinations, including for example the WaterShare+ scheme introduced by South West Water[153] and commitments made by United Utilities to its CommUnity Share scheme.[154] We encourage companies to put forward voluntary sharing arrangements at PR24 which we will assess as part of the ambition assessment of business plan incentives, as set out in Chapter 11.

9.8 Consultation questions

Q9.1. Do you agree with the proposed standard set of scenarios for testing financial resilience?

Q9.2. Do you agree with our approach to how the board of the company should approach its board assurance statement?

Q9.3. Do you agree with our proposed approach to dividend policies, performance related executive pay and voluntary sharing of financial outperformance?

[153] South West Water, 'WaterShare+, sharing our success'. WaterShare+ is designed to give customers a greater say in how the company is run and provides financial benefits to customers where South West Water outperforms its business plan. South West Water set out in its business plan for 2020-25 that this includes net financing outperformance relating to debt raised in previous regulatory periods.

[154] United Utilities proposed £71 million of its own money over the price control period for its CommUnity Share. This was a guaranteed shared amount before considering any dividend payments to provide financial assistance schemes for customers in need of financial support. Where dividend distributions to shareholders exceeded a pre-defined limit, United Utilities committed to match these with contributions to its CommUnity Share scheme.

10. Companies' PR24 submissions

10.1 Introduction and summary

At PR24 we want the sector to deliver for the long term, delivering greater environmental and social value, reflecting a clearer understanding of customers and communities, and driving improvements through efficiency and innovation. This chapter sets out some specific expectations for company price review submissions, principally the business plans including the long-term strategies and the business plan data tables.

It covers:

- company business plans and narratives (section 10.3);
- long-term delivery strategies (section 10.4);
- the supporting data tables (section 10.5);
- early data submissions (section 10.6);
- approach to new appointees (section 10.7);
- approach to single social tariffs in business plans (section 10.8);
- assurance and governance expectations (section 10.9); and
- our proposed approach to reconciling past performance (section 10.10).

Our expectations for assurance and governance link to our aims in Chapter 11 where we describe how we intend to use business plan incentives at PR24. We outline what we want to see in companies' price review submissions, and the incentives we are providing to encourage them to deliver this. That is, we want to incentivise all companies to provide quality and ambitious plans that will deliver stretching levels of service at efficient cost and affordable wider value for customers, communities and the environment.

10.2 Key messages

- We have reviewed our approach to the business plan submission taking on board the lessons learned from our experience of PR19 and feedback from companies.
- Where possible, our table formats follow an equivalent APR table, and the table definitions have been redrafted in a style which is similar to that found in RAG4.
- We have specified limits for document size and number, this will enable us to handle the submissions in a timely way and help us to focus on the important issues raised in the submissions.
- Our proposals contain expectations for board assurance of specific aspects of the PR24 submission which should be provided as part of an overall assurance statement.

10.3 Expectations for company business plans and narratives

Chapter 11 and Appendix 12 detail how we propose incentivising companies to submit the best possible business plans. The business plan incentives assessment will consider data, information and assurance; costs; outcomes; long term delivery strategies; customer affordability and acceptability; and risk and return.

Overall, it is for companies to decide the best way to present their proposals. But we do expect companies' business plans to adopt some common structure. Reflecting on our experience of PR19 we also propose introducing some degree of restriction and standard formats to provide clarity and transparency for stakeholders. We expect plans to be more focused and succinct, more accessible and easier to navigate than in PR19. This section provides some further specific proposals that we want companies to follow when submitting their business plan.

We expect submissions to include all the relevant data and information as requested in our methodology and business plan tables, and to be consistent, accurate and assured. The evidence companies provide in their business plans about how they have assured themselves that data is consistent and accurate, and the process their boards have followed to challenge management to deliver a high-quality plan, will help provide us with confidence in the plans. Section 10.9 provides further details of our expectations around assurance and governance.

We expect companies to publish all documents on their websites[155] at the same time as they submit them[156] to Ofwat;

In terms of submission content, we propose that:

- submissions will contain a well written main business plan narrative in a single document that clearly and succinctly explains the company's proposals and summarises how the company will deliver our key PR24 ambitions – limited to 200 pages for water only companies and 300 pages for water and sewerage companies;
- companies should provide a guide to reading the plan which contains hyperlinks to all documents;
- companies should clearly cross reference between commentaries, tables and the business plan main narrative;
- companies should provide clear, succinct commentaries (in 12 separate pdf documents corresponding to the table groupings) to accompany individual business plan tables, avoiding duplication of text elsewhere in the plan and including appropriate cross references;

[155] If a company considers some information should not be published – because it is commercially sensitive information, for example – then the company will need to provide its stakeholders and us with strong, robust reasons that are specific to the information concerned.
[156] Companies who choose to submit their plans early can publish their plans when they wish but must do so no later than our deadline.

- there should be an overall limit to the number of documents in the submission; 80 for WaSCs and 50 for WoCs;
- there should be a limit of 25MB for each document submitted;
- companies should use a searchable pdf format for most documents except for our table templates (duplicate documents in MS word are not required) and supporting excel files that may be submitted;[157]
- each document should use a filename with the OFWAT company acronym and a 2 digit numerical reference – eg "TMS27"; and
- submissions should not contain any video files.

10.4 Long-term delivery strategies

Companies should set out their five-year business plans in the context of a 25-year long-term delivery strategy. This will help ensure that what is delivered in the short term is likely to maximise long-term value for customers, communities and the environment.

Our final guidance on long-term delivery strategies outlines our full requirements for what companies should include in their strategies at PR24.[158] This includes:

- presenting key enhancement activities using adaptive pathways, including a core pathway of low-regret investment and investment to keep future options open, and alternative pathways which could be triggered depending on how future uncertainties develop;
- testing against future scenarios, including the common reference scenarios, alongside wider scenario testing as appropriate; and
- providing a clear, holistic narrative on how the company expects to meet its long-term ambition, including its approach to maintaining and improving existing assets as part of base activities.

The long-term delivery strategy should be fully consistent with the PR24 business plan. Across the PR24 submission, the company should present a single adaptive strategy, rather than multiple alternate plans. The strategy should be no more than 100 pages for water-only companies and 150 pages for water and sewerage companies.

In early 2023, we will provide a voluntary opportunity for companies to receive high-level feedback on the development of their long-term delivery strategies. We will invite companies to present a summary of how they are developing their long-term delivery strategy. Our subsequent feedback will focus on their development in line with our guidance. We will provide further details to companies later this year.

[157] We will continue with our approach of publishing financial models and supporting feeder models, to promote transparency and understanding of our decision making.
[158] Ofwat, 'Final guidance on long-term delivery strategies', April 2022.

10.5 The supporting data tables

We will use Excel templates for the business plan tables as we did at PR19. We have made improvements to the process by learning from our experience of PR19, including:

- Ensuring that a significant proportion of the table formats closely mirror their annual performance report (APR) equivalents (with line definitions clearly cross-referenced). We expect that this will reduce the number of queries from companies as they should be familiar with the requirements for those tables.
- Grouping the tables into subject areas, each having their own guidance document for completing the tables which follows the regulatory accounting guidelines (RAGs) style. We will similarly expect companies' table commentary documents to be grouped in this way.
- Having a process for companies to raise queries on the business plan requirements, but we will impose strict deadlines for companies' queries. We will set out the timelines for this when we publish our final methodology.

At this stage of the consultation we have not included all formulae in the excel tables. The supporting documentation will set out the expected approach for calculated cells. We expect that responses to the consultation should reflect this and focus on more general aspects of the proposed data to be collected rather than on detailed observations. As our methodology is finalised, we will provide a process for companies to query the definitions at a detailed, working level.

10.6 Early data submissions

As we develop our policies for PR24 it is likely that we will continue to request data from companies in advance of the business plan submissions to assist us in this. In IN 22/01 - Expectations for monopoly company annual reporting 2021-22 (March 2022) we set out seven areas where further information outside of the APR and the business plan is to be used as we develop our approach to PR24.

Our final methodology will set out in detail the extent and timing of these and any additional requests in a transparent manner. This may include areas such as past performance and PR19 reconciliation models. During PR19 we requested the equivalent data in July 2018 ahead of business plan submission.

10.7 Approach to new appointees

The new appointments and variations (NAV) framework enables new entrant companies (new appointees) to replace an existing company (incumbent) as the provider of water and/or wastewater services in a specific geographical area in England and Wales.

We seek to ensure that our regulation of, and interactions with, new appointees are proportionate to the risks to customers and size of new appointees. In practice this means that we have not conducted price controls for new appointees and do not propose to do so as part of PR24. Instead, each new appointee's licence (Condition B) includes a relative charge control, which prevents the new appointee from levying charges that are higher than the incumbent water company. As a consequence, we do not require new appointees to submit business plans or supporting business plan data tables.

10.8 Approach to single social tariffs in business plans

The UK and Welsh governments are considering the role for, and potential form of, a single social tariff scheme for the water and wastewater sector, following on from the recommendation made by CCW in its independent water affordability review. It is proposed that, subject to final decisions, any resulting scheme will be introduced from 1 April 2025.

We will work with UK and Welsh governments to understand the impact of their final decisions for the price review. We do not currently know when the full details of any scheme, how it will operate and what it means for each company, will be confirmed.

Consequently, our current expectation is that each company should cover two scenarios in its business plan. First, it should be clear how its proposals would deliver on a legislative requirement to implement a single social tariff and its forecast impact. This should include how the company would assess the needs of and support customers currently in receipt of social tariffs who would not be eligible for support under a single social tariff scheme. The UK and Welsh governments' proposal of a new mandatory scheme aims to introduce universal eligibility criteria and a standard approach to determining levels of support. This new scheme would replace companies' current social tariff arrangements. Therefore, companies are not required to obtain customer acceptability for a new scheme.

Second, it should set out its proposals if a single social tariff is not in place for 1 April 2025. For this second scenario, we expect companies to provide forecast data based on their proposed social tariff offering in line with existing guidance and the current legal framework. We also set out our expectations that companies engage customers in Chapter 4.

Both scenarios should be accompanied by a commentary on proposals, including details of other forms of affordability support being provided for customers struggling to pay their bills in addition to social tariffs or a single social tariff scheme. Companies should explore how they could best provide significant support and introduce innovative methods to support customers under each scenario we have set out. We will consider the ambition demonstrated in their proposals in our business plan incentives assessment.

10.9 Assurance and governance expectations

Good assurance and governance of PR24 submissions is vital if stakeholders, including Ofwat, are to have confidence in the information presented in them. The submission can only be of high quality where there are **assurance** checks on the systems and processes for developing the business plan, the production of the data and information and when stakeholders have confidence that a company's full board has been integral to the **governance** surrounding the submission.

It is for the companies and their boards to determine the role that assurance plays in this process, including the role of external assurance. We expect company boards to own and be accountable for their submissions and the business planning processes that underpin all aspects of the plan.

10.9.1 Board governance

We expect the board to consider how it satisfied itself that the **systems, approach to risk management, and internal controls and processes** in place to develop the data and information on which it based its decisions was appropriate and effective. The board should be confident that the overall strategy for data assurance and governance processes delivers high-quality data across all aspects of the plan and long-term delivery strategy. It should be confident that it had access to a complete and transparent view of the company's historic and expected performance when making decisions and that it is satisfied that all the elements add up to a submission that is high quality in the round.

The company's board should challenge and satisfy itself that its submission will deliver operational, financial and corporate resilience[159] over the next control period and long term. This includes a clear responsibility to ensure that the company can meet its statutory obligations, now and in the future.

The board should also be involved with the testing of assumptions that underpin the submission. It should be fully aware of the impact that alternative assumptions may have. In particular we expect that the range of skills and experiences from the whole board be used to test the impact of the assumptions on the wider stakeholder base.

We would expect the boards of each company in Wales to satisfy itself that the long-term strategies take into account the outputs of the **collaborative approach**[160], as well as what is learnt from wider stakeholder and customer engagement.

[159] We define corporate resilience as the ability of an organisation's governance, accountability and assurance processes to help avoid, cope with and recover from, disruption; and to anticipate trends and variability in its business operations.

[160] The collaborative approach in Wales is explained in section 4.5 of Chapter 4.

10.9.2 Specific areas of assurance of plans by company Boards

Our expectations for board assurance of specific aspects of the PR24 submission are set out in Table 10.1. These should be provided as part of an overall **assurance statement** by each company's full board.

Table 10.1 Proposals for areas of specific board assurance

Area	Board assurance requirements
Long-term delivery strategies	That the board has challenged and satisfied itself that the long-term delivery strategy is high-quality. See section 3.6 of PR24 and beyond: Final guidance on long-term delivery strategies for full expectations on board assurance for long-term delivery strategies.
Affordability	That the board has challenged and satisfied itself that: ▪ the full implication of the 2025-30 business plan for customers was considered and that the plan achieves value for money; and ▪ the long-term delivery strategy protects customers' ability to pay their water bill over the long term and delivers fairness between what existing customers will pay and what is paid for by future customers.
Costs and outcomes	That the board has challenged and satisfied itself that: ▪ the performance commitment levels in the plan are stretching but achievable and reflect performance improvements expected from both base and enhancement expenditure; ▪ the plan includes price control deliverables covering the benefits of material enhancement expenditure (not covered by performance commitments); ▪ the expenditure forecasts included in the company's business plan are robust and efficient; ▪ the options proposed within the business plan are the best option for customers and a proper appraisal of options has taken place; ▪ the plan and the expenditure proposals within them are deliverable and that the company has put in place measures to ensure that they can be delivered; ▪ that the expenditure proposals are affordable by customers and do not raise bills higher than necessary; and ▪ the expenditure proposals reflect customer views, and where appropriate are supported by customers.
Risk & return	**Financeability** That the board should: • provide assurance that the business plan is financeable and consistent with maintaining the

	target credit rating on the basis of the notional capital structure and provides sufficient headroom to a minimum investment grade credit rating under stress scenarios, taking account of mitigating actions. We expect companies to provide evidence of the steps taken by their board in giving that assurance; and • take account of all components of the business plan and set out clearly the steps taken to provide assurance, including the consideration of the financial ratios. See Chapter 8 for further details. **Financial resilience** That the board should: • provide an assurance statement that the actual company is financially resilient over the period of the price review and beyond under its business plan; and • set out the steps it has taken to enable it to make that statement, the factors it has taken account of, and the suite of financial metrics used to ensure the company is financially resilient. We expect the plan to demonstrate the basis on which the assessment has been carried out, including how the base case and downside scenarios have been established and assessed. See Chapter 9 for further details.
Customer engagement	That the board should provide assurance that the company's customer engagement and research meets the standards for high-quality research and any other relevant statements of best practice and has been used to inform its business plan and long-term delivery strategy.

10.10 Reconciliation of past performance

At PR24 we will need to reconcile companies' 2020-25 performance against the PR19 final determination. This requires us to assess company reported costs and performance for 2020-25 and ensure we adjust company revenue and RCV appropriately against the incentive mechanisms and reconciliation true ups included in the PR19 final determination. We will also need to:

- reconcile a small number of additional reconciliation models that will apply for those companies that received Green Recovery funding in July 2021; and

- take into account some elements of the 2019-20 Blind year[161] adjustments, which were not accounted for at PR19 or during 2020-25.

We provide further information on the reconciliation models, how they operate and how adjustments will be applied in Appendix 13. The appendix also confirms which of the 2019-20 blind year adjustments will be made as part of PR24 and which were made during 2020-25.

In making these reconciliations at PR24, we propose the following in relation to:

- how we will apply past performance reconciliation adjustments to 2025-30 price controls;
- making 2024-25 blind year adjustments; and
- business plan submission expectations for past performance.

10.10.1 How we will apply past performance reconciliation adjustments to 2025-30 price controls

When we make adjustments to 2025-30 price controls for past performance, we will:

- apply each adjustment in the appropriate control (as specified in the rulebook for each reconciliation) and consider over what period each should be applied; and
- apply RCV adjustments as midnight adjustments on 1 April 2025.

For water trading incentives revenue adjustments, companies will need to allocate the incentive payments from new water trades in the 2020-25 period between the water resources and network plus water revenue controls. We would expect companies to set out their approach for allocating incentive payments which we will review.

Consistent with previous price reviews, at PR24 we propose the following:

- Retaining the flexibility to apply revenue adjustments either in the first year or spread over a number of years in the new price control period (preserving the net present value of the reward or penalty due).
- Expecting companies to make any specific proposals, providing evidence that they have considered the impact of their proposals on customers both now and in the longer term and evidence of customer views on the chosen bill profile.

161 The blind year refers to the final year of the control period, where actual performance data is not available until after we set final determination for a price review. At PR19 we used forecast performance for 2019-20. We then calculated and we published the difference between the forecast and actual performance in 2020.

- Applying revenue adjustments to the controls after financeability has been assessed. This is to ensure incentives for companies are not diluted and customers do not compensate companies for prior poor performance.

10.10.2 Making 2024-25 blind year adjustments

In the same way that we had to adjust revenue and RCV to reflect 2019-20 blind year performance, we will also need to adjust for 2024-25 blind year performance.

We propose using a similar process for making 2024-25 blind year adjustments to the one used for 2019-20 blind year adjustments. This means that we would:

- include an adjustment factor within the RFI formula that will be set out in the formal notification letters at PR24 final determination;
- calculate the required 2024-25 blind year revenue and RCV adjustments in 2025-26; and
- allow companies to recover defined elements of the 2024-25 blind year revenue adjustments during the 2025-30 control period. Companies would have the flexibility to decide the proportion of the 2024-25 blind year adjustments recovered in each of the remaining years of 2025-30, but we would expect them to do so in a way that is demonstrably in customers' best interests (see Chapter 3 for further details of the RFI and this process).

In the PR19 Reconciliation Rulebook we said that, for in period ODIs only, we would not set revenues for 2025-30 at PR24 using forecast performance in 2024-25. We said we would make any subsequent blind year adjustment for in-period ODIs using the in-period adjustments model to inform our in-period determination in late 2025, adjusting allowed revenues in 2026-27. We are considering whether this remains the most appropriate approach or whether we should continue to include forecast data for 2024-25 ODIs as we did at PR19. We welcome views from stakeholders on this.

10.10.3 Business plan submission expectations for past performance

Accounting for past performance

We would expect companies and their boards to carefully consider how their performance during 2020-25 should inform their proposals for 2025-30 and beyond. While the price review reconciles differences in a company's actual performance compared to its final determination and makes revenue and RCV adjustments, we would expect companies to look beyond the financial impact.

We would expect companies to want to understand how their performance affects customers and the environment and to be able to demonstrate how their understanding of the drivers of good and poor performance informed their business plan proposals. Details of our approach to setting performance expectations and funding service enhancements are set out in chapters 5 and 6.

Requests for interventions on PR19 reconciliation models

At previous price reviews, when submitting past performance information in business plans, some companies have asked us to intervene on the operation of individual reconciliation models.

Our expectation is that companies should not be seeking to override or amend the adjustments that flow from the PR19 reconciliation models. The policy and decisions that the mechanisms are designed to enact, and the basis of any opportunity for interventions, are set in the final determination for the period. Companies accept these as part of the determination. The detailed operation of the reconciliation models is confirmed through the Rulebook, first published in 2021 following consultation. In many cases companies had sight of how the models would operate earlier in the PR19 process.

However, there are a small number of areas where we indicated that a company might make a request for an intervention. For example, in the PR19 final determination, we said that companies could make a case for an intervention on penalty payments incurred under the RFI, where they related to variance in developer services revenue. More recently, due to the Covid-19 pandemic we indicated that we may consider the impact of Covid-19, and specifically the impact on the Per Capita Consumption performance commitment during 2020-25.

If a company makes an argument for intervention in these areas, we expect the company to be able to clearly demonstrate the basis of its case, the impact and reasons why an intervention represents a material improvement which is in customers' interests.[162] We would

[162] We describe the expectations in relation to Covid-19 impact in more detail in Ofwat, 'IN 21/01 Expectations for monopoly company annual performance reporting 2020/21', April 2021. We explained our approach to PCC in

expect to consider any proposal in the wider context of how the company has performed and how that compares with other companies within, and outside, the sector. There is a high bar for any such interventions, companies must provide compelling evidence and should not expect to be insulated from exceptional events.

Feeder models for 2019-20 blind year and PR19 reconciliation models

We propose using two feeder models to take the outputs from the 2019-20 blind year and PR19 reconciliations and convert them for use in the financial model. These are the revenue adjustments model and RCV adjustments model.

The first will profile the revenue adjustments in the 2025-30 price controls and direct the profiled revenue adjustments to the right price control in the financial model. The second will direct the RCV adjustments from the reconciliations into the right price controls. We set out further details of our expectations on business plan tables for past performance in Appendix 13 – Data and Modelling. We also expect companies to publish their populated PR19 reconciliation models.

10.11 Consultation questions

Q10.1. Are the PR24 submission requirements clear and sufficiently specified?

Q10.2. Is any data missing, or included but not required or areas we need to look at again?

Q10.3. Are the limits on the number and size of documents workable? Should we be more prescriptive in terms of file and folder structures etc?

Q10.4 Do our expectations for company board's assurance and governance arrangements provide enough guidance to ensure that boards have sufficient level of 'ownership' and so ensure a high quality submission?

Q10.5. Do you agree with our proposal to continue to apply revenue adjustments for past performance across all years of 2025-30, after the financeability assessment?

Q10.6 Do you agree with our proposal for 2024-25 blind year adjustments? Should we treat in period ODI adjustments in the same way as other blind year adjustments or retina the approach set out in the Rulebook?

Ofwat, 'Consultation on changes to per capita consumption performance commitments – our decision on reporting performance and ODI timing', November 2021.

Bioresources specific questions[163]

Q10.7. Do you have any comments on how to best deal with the impact of shadow and non-shadow reporting in table BIO3 on other tables?

Q10.8. Do you have any comments on the data we should collect in table BIO5?

[163] Further background on this can be found in PR24 submission table guidance - Section 6: Bioresources.

11. Encouraging quality and ambitious business plans

11.1 Introduction and summary

The sector needs to confront major challenges in the coming years. Companies' price review submissions will play an important role in this process, by demonstrating how they will meet these challenges and outlining the levels of performance they will deliver. We will use this information to drive better outcomes for all customers, communities and the environment. In this chapter, we describe our proposed approach to using business plan incentives at PR24.

Our goal is to incentivise all companies to propose business plans with stretching levels of service at efficient cost and deliver affordable wider value for customers, communities and the environment. Companies also need to provide us with the information we need to conduct the price review efficiently and effectively.

We will use business plan incentives to encourage companies to submit quality plans that are also ambitious. We propose to use a range of reputational, financial and procedural rewards and penalties at PR24 to achieve this.

This chapter sets out:

- what we want to see in companies' price review submissions; and
- the incentives we propose to use to encourage them to deliver this.

11.1.1 Key messages

We propose an approach which:

- Provides incentives for companies to submit quality and ambitious business plans through a combination of **reputational, financial and procedural incentives.**
- **Categorises companies** into four categories: Outstanding – sets the bar for others; Standard – generally good; Lacking ambition – improvements required; and Inadequate – significant improvements required.
- **Rewards** companies that submit ambitious plans for the 2025-30 period.
- Also uses **penalties** to ensure all companies are incentivised to exceed our expectations with a quality and ambitious plan on first submission.

We include business plan incentives in our proposals for PR24 because:

- They **delivered good results for customers, communities and the environment** at PR19 and PR14 when we were able to use the information provided in the best plans to challenge the rest of the sector.
- Companies providing the best business plans can **turn their attention more quickly to delivery for customers, communities and the environment**. It also means that we can target our attention on driving improvements where plans need further work.

Our proposals for the rewards and penalties associated with PR24 business plans are summarised in **Table 11.1**.

Table 11.1 summary of proposed company categorisation at PR24

Company categorisation	Business plan characteristics	Financial & procedural rewards and penalties
For companies that pass our quality assessment:		
Outstanding – sets the bar for others	Demonstrates significant ambition.	Financial adjustment equivalent to **+ 30 bps return on regulated equity** **Protection from reductions** in allowed return on capital and base cost allowances between draft and final determination **50:50 cost sharing** - Company can recover 50% of cost overspend from customers and can retain 50% of underspend
Standard – generally good	Demonstrates modest ambition.	Financial adjustment **equivalent to 0 to + 10 bps return on regulated equity equivalent** (each adjustment will be dependent on the ambition demonstrated) **50:50 cost sharing** - Company can recover 50% of cost overspend from customers and can retain 50% of underspend
Lacks ambition – improvements required	Demonstrates insufficient ambition.	Financial adjustment up to an equivalent of **– 30 bps return on regulated equity** **55:45 cost sharing** - company must incur 55% of cost overspend and may only retain 45% of underspend
For companies that fail our quality assessment:		
Inadequate – significant improvements required	Is of insufficient quality.	Financial adjustment equivalent to **- 30 bps return on regulated equity** **60:40 cost sharing** - Company must incur 60% of cost overspend and may only retain 40% of underspend

The reminder of this chapter covers:

- **our proposed framework for encouraging the best possible business plans**, which focuses on the aspects of plans we will incentivise through business plan incentives (**section 11.2**); and
- **the package of reputational, financial and procedural rewards and penalties** we propose to offer to encourage companies to submit their best possible plans on first submission (**section 11.3**).

We provide further details of our proposed framework for applying business plan incentives, and our rationale for key proposals, in Appendix 12 – Business plan incentives.

11.2 A framework for encouraging the best plans

This section outlines our proposed framework for applying business plan incentives at PR24. We propose a framework comprised of two parts. First, we propose to assess whether companies' business plans are of sufficient quality. We then propose to assess the level of ambition they demonstrate. The proposed scope of our assessments of 'quality' and 'ambition' and our proposed approach for determining rewards and penalties is summarised in **Figures 11.1** and **11.2** below.

Figure 11.1 Proposed scope of PR24 business plan assessment

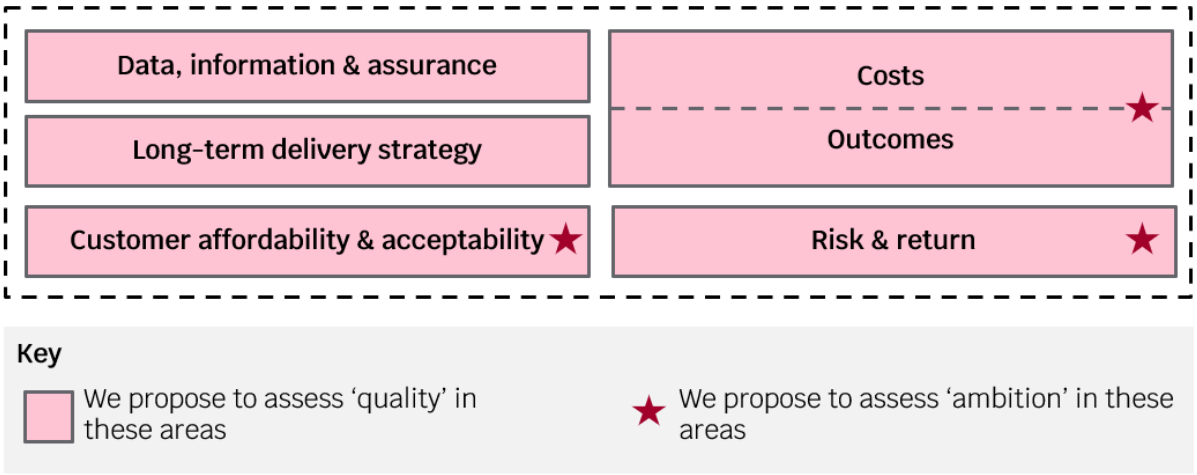
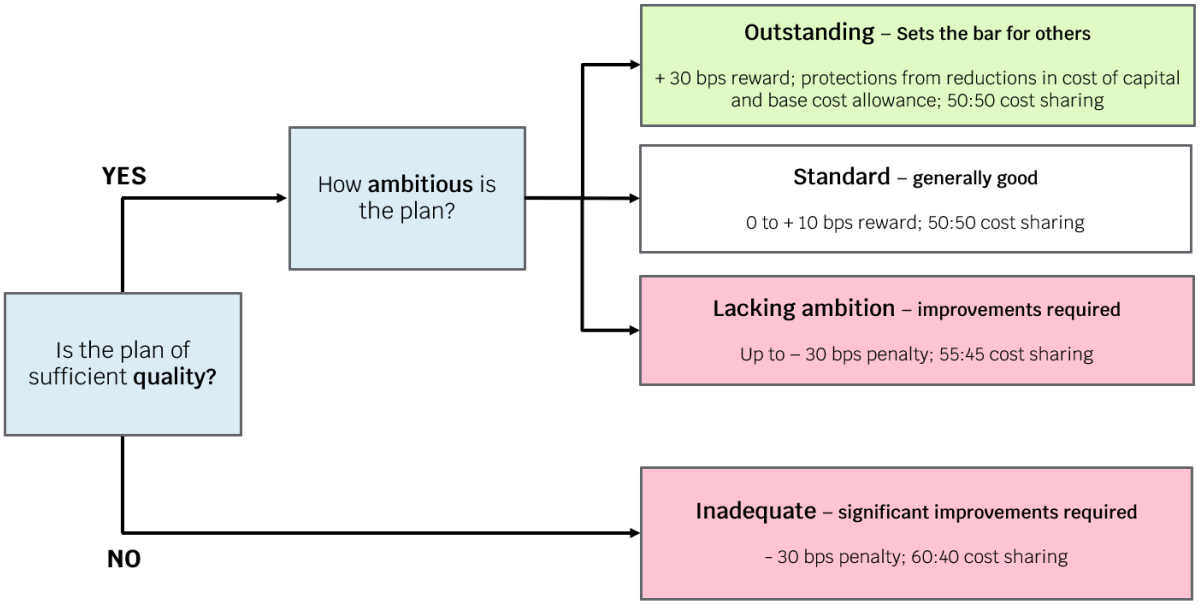


Figure 11.2: Proposed framework for determining business plan rewards and penalties



Quality assessment

It is important that companies provide business plans that:

- include the evidence we require and to the standard we require. This is sufficient and convincing or, in some cases where set out, compelling;
- use our assumptions; and
- address any feedback that we have provided.

We propose to consider this in our quality assessment, in which we will assess whether plans meet a set of minimum expectations.

We consider that all companies should be able to meet our minimum expectations in the round. Therefore, we do not propose rewards for the quality part of the assessment. It is important that companies submit their best plans at the start of the process and so we will penalise companies that fail our quality assessment. Companies that fail on quality will also be ineligible for rewards in the ambition part of the assessment. Although all companies may have to provide better evidence or revise their business plans, companies that fail our quality assessment will have to make significant changes to their plans.

The quality assessment will cover six areas:

- data, information and assurance;
- long-term delivery strategy;
- customer affordability and acceptability;
- costs;
- outcomes; and
- risk and return.

We provide an overview below of what the assessment will cover in each of these areas, and outline our specific minimum expectations and references to more detailed guidance in Appendix 12 – Business plan incentives. Companies should ensure that they follow the detailed guidance in the appendix when preparing their PR24 business plans.

1. Data, information, and assurance

Here we propose to assess whether companies have complied with our expectations for the business plan submission. We propose our assessment will include, for example, whether business plan submissions are complete, including data tables, commentaries, models and long-term delivery strategies as appropriate. Practically, this means we will be looking for whether the company provides:

- the data and information as requested in our methodology and business plan tables. This must be consistent, accurate, assured and comply with the page and document limits we have specified;
- A long-term delivery strategy which is fully consistent with the PR24 business plan. Furthermore, across the PR24 submission, the company presents a single adaptive strategy, rather than multiple alternate plans; and
- assurance statements we have requested from the company's board.

2. Long-term delivery strategy

Here we will assess whether companies have developed their long-term delivery strategies in line with our final guidance. We propose to assess whether strategies:

- set out all key enhancement activities in terms of adaptive pathways, with appropriate use of trigger and decision points;
- have been tested against our common reference scenarios, alongside wider scenario testing as appropriate; and
- are supported by robust evidence.

3. Customer affordability and acceptability

Customers across England and Wales face significant cost of living pressures. We expect business plans to have considered affordability overall, for current and future customers, and for residential customers who may struggle to pay their bills. Our proposed assessment of whether business plans meet our minimum expectations for affordability and acceptability comprises of whether each company's:

- plan and long-term delivery strategy explain how it has taken account of views on affordability for all customers and those who struggle to pay their bills, including how its strategy considers affordability in the long term. We also expect each company to

explain how it will deliver fairness for both future and existing customers in relation to what they each pay for.
- plan demonstrates it has used our standardised methodology for testing the affordability and acceptability of its proposals; and
- plan includes proposals for supporting customers struggling to pay their water bills through social tariffs and other methods of support under our specified scenarios.

We also expect the company's submission to demonstrate that its customer engagement activities meet our standards for high quality research, challenge and assurance. We propose to take account of evidence of customers' views on specific proposals in the relevant business plan incentive assessments across costs, outcomes, and risk and return.

4. Costs

Our proposed assessment of whether business plans meet our minimum expectations for costs is whether each company's plan and, where relevant, its long-term delivery strategy:

- sets out the benefits of its proposals and, wherever appropriate, reflects these benefits in performance commitments and price control deliverables;
- is consistent with the achievement of government targets and statutory obligations. In Wales this includes demonstrating how companies have taken into account the outputs of the collaborative approach;
- includes investment options which are consistent with the company's finalised water resources management plan, final water industry national environmental programme/ national environment programme submission and, if applicable, drainage and wastewater management plan, having adequately addressed any feedback previously provided on these. We also expect evidence on the need for variations from final plans, if relevant; and
- proposes investments to be delivered via direct procurement for customers (DPC), in line with our 'DPC by default' approach.

5. Outcomes

The outcomes component of our assessment considers whether plans meet our minimum expectations for outcome delivery incentives and bespoke performance commitments.

We will consider whether the company's plan contains incentive rates for common performance commitments 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 should include evidence, consistent with any relevant guidance.

Bespoke performance commitments might be appropriate in a small number of cases at PR24. If any are included in business plans, then we expect companies to demonstrate why each is justified, or how they have addressed any feedback we have previously provided on their proposed definitions. Companies should also provide complete, consistent and well-

evidenced incentive rates for their proposed bespoke performance commitments, in line with our draft methodology and any relevant guidance.

6. Risk and Return

Our proposed assessment of whether business plans fulfil our minimum expectations for risk and return includes whether the company's plan:

- uses our 'early view' of the allowed return on capital or provides evidence that another rate is more appropriate;
- includes evidence to support its overall balance of risk and return;
- includes board assurance that its plan is financeable on the basis of the notional capital structure, supported by evidence to support this;
- includes board assurance, that it will maintain financial resilience in 2025 to 2030 and in the long term taking account of its business plan under its financing and capital structure. We expect this to be supported by evidence of the steps taken to provide the assurance and of steps to improve financial resilience where necessary; and
- includes dividend and executive pay policies for 2025-30 that are consistent with our guidance.

Ambition assessment

We want PR24 business plans to include ambitious proposals that reveal where companies can stretch themselves to deliver more for their customers, communities and the environment during the next price control period.

As set out in this chapter, companies which fail our quality assessment will be ineligible for rewards and would receive the maximum penalty. For companies that pass our quality assessment, we propose that the level of ambition demonstrated in a company's submission should determine whether they receive a business plan penalty or reward. Specifically:

- companies that pass our quality assessment should receive rewards when their plans also include ambitious proposals; and
- companies that pass our quality assessment but demonstrate a lack of ambition should receive penalties in this part of our assessment.

We will continue to place a strong emphasis on stretch and efficiency at PR24. Consequently, we propose that ambitious plans will include **stretching but achievable levels of service at an efficient cost to customers**. Our assessment will include considering the extent to which:

- Companies propose to deliver stretching performance from base expenditure allowances;
- Expenditure proposals are efficient and consistent with our stretching efficiency benchmarks, with any cost adjustments based on compelling evidence;

- Enhancement expenditure is well justified, based on adaptive plans, meets customer and environmental needs and makes progress towards delivering government targets; and
- Companies propose to deliver best value solutions, by considering wider environmental and social benefits, costs, risks, opportunities for third party funding and the affordability of customers' bills.

Companies' ambition must take account of affordability concerns. We will support overall affordability by considering value for money in our assessments of stretch and efficiency. We also want companies to explore how they can demonstrate ambition to further enhance overall affordability, including for residential customers struggling to pay. We propose to reward companies that:

- engage meaningfully with their customers to understand their priorities for improved outcomes for those customers, communities and the environment for 2025-30 and beyond, and how statutory outcomes are delivered, taking into account affordability concerns. Companies would be expected to demonstrate how their customers' preferences are reflected in their overall business plans, for example in decisions about how they propose to phase investments and service improvements; and
- propose high value or innovative ways of supporting customers, eg through voluntarily sharing outperformance (see **Chapter 9**) or making other contributions from investors. This support may be targeted at, but should not necessarily be limited to, residential customers struggling to pay.

These rewards for enhancing affordability will be dependent on whether we consider a company's plan overall represents value for money.

11.3 The rewards and penalties

We propose to use reputational, financial and procedural rewards and penalties to encourage companies to provide quality and ambitious business plans. We outline these below and discuss the rationale for key proposals in **Appendix 12 – Business plan incentives**.

We want companies to make their first submission their best possible submission and propose that the strongest rewards are reserved for those companies. Although we may – exceptionally – move a company out of the lowest categories, we will ensure that they will be worse off than those companies that provided their best plan at the first opportunity.

Reputational

At PR24, we plan to assign each company to one of four categories, which are described in **Table 11.1** above.

The reputational impact of the categorisations will be significant. During the price review, companies will be branded by their category and we will refer back to these frequently in our PR24 communications and beyond. We will also expect companies to state their category prominently on direct communications with their customers and stakeholders, for instance in annual reports and on their websites, making the outcome of our assessment visible to a broad range of parties.

Financial

Companies need to stretch themselves to deliver their most ambitious plans on first submission. We will incentivise this with strong financial rewards for those who submit ambitious plans, and financial penalties where companies fall short.

Therefore, at PR24 we plan to offer directly applicable financial rewards. We also propose to couple financial rewards with financial penalties if business plans are of insufficient quality or lack ambition, which will directly reduce some customers' bills.

Table 11.1 demonstrates the financial rewards and penalties we propose to offer at PR24, where adjustments are capped at an equivalent of a +/- 30 basis point adjustment to the return on regulated equity. Companies can choose to receive their reward, or incur their penalty, as adjustments to revenue or their RCV during 2025-30.

We will also use pre-determined cost sharing rates for 2025-30 using companies' categorisation, as shown in **Table 11.1**. Companies achieving higher categorisations will receive more favourable rates than those in lower categories.

Procedural

We also propose to protect companies that achieve our highest categorisation from potential reductions in the allowed return on capital and base cost allowances between draft and final determinations. These companies would still be eligible to benefit from any increases between draft and final determinations. They will be able to reduce their engagement in the price review and focus on delivery for their customers, communities and the environment.

11.4 Consultation questions

Q11.1. Do you agree with the framework we propose to encourage the best business plans? Specifically, do you agree

- that we should first assess 'quality' followed by 'ambition'?

- with our proposed allocation of rewards and penalties for performance on each?

Q11.2. Do you agree with the proposed scope of our 'quality' assessment? Specifically, do you agree:

- we should have minimum expectations in the six areas described above?
- with the minimum expectations we specify in each of the six areas?

Q11.3. Do you agree with the proposed scope of our ambition assessment?

Q11.4. Do agree with our proposed reputational, financial and procedural rewards and penalties, including the overall package of reward and penalty?

Q11.5. Do you have any other comments regarding our proposed approach to business plan incentives at PR24?

List of consultation questions

Ch2 – Regulating through the price review

Q2.1: Do you agree with the challenges facing the sector and the ambitions for PR24 we have identified?

Q2.2: Do you agree that continuing to use our three building blocks helps push companies to meet our ambitions for PR24?

Q2:3: Do you agree that we have struck the right balance between what's in and what's outside of the price control?

Q2.4: Do you have any comments on our approach to evaluating progress? What specific evaluation questions (based within the four key ambitions) do you think an evaluation should look to answer?

Ch3 – Design and implementation of price controls

Q3.1. Do you agree that in our final methodology we should commit to introducing either an adapted water trading incentive or a new water trading incentive at PR29? If you have a preferred approach, please provide reasons, including any thoughts on how the options we set out in Appendix 2 could be improved.

Q3.2. Do you agree with our proposals to:

a) Continue to include network reinforcement in the network plus price controls?

b) Remove wastewater site-specific developer services from the wholesale wastewater network plus price control?

Q3.3 Do you agree that the inclusion of network reinforcement in cost sharing would be enough to manage uncertainty around the volume and mix of network reinforcement work to be delivered?

Q3.4. For water site-specific developer services:

a) Do you agree with our proposal to exclude new developments of more than 25 properties from the wholesale water network plus price control at PR24, but with transitional arrangements for companies with low levels of competition?

b) Do you think that new developments of 25 properties and fewer should remain in the wholesale water network plus control or be removed? If they were removed from the

price control, what alternative protections could we introduce to protect new connection customers from monopoly power?

Q3.5. Do you agree with our proposals:

a) To raise the size threshold above which companies should deliver schemes through DPC to around £200m lifetime totex?

b) For companies to deliver schemes through DPC by default above this threshold?

Q3.6. Do you have any views on any other aspect of our proposals in relation to:

a) The design of price controls;

b) Water resources;

c) Developer services;

d) Retail activities;

e) Bioresources;

f) Other controls;

g) The revenue forecasting incentive mechanism; or

h) Direct procurement for customers?

Ch4 - Reflecting an understanding of customers and communities

Q4.1. Do you agree with our approach to making sure that companies' price review submissions and our determinations reflect an understanding of customers', communities' and environmental concerns?

Q4.2. Do you agree with our proposal to conduct open challenge sessions?

Q4.3. Do you have views on open challenge sessions can align with the collaborative approach in Wales?

Q4.4. Do you have views on how the outcome of collaborative customer research can contribute in the context of the collaborative approach in Wales?

Ch5 – Delivering outcomes for customers

Performance commitments

Q5.1. Do you agree with our proposed package of common performance commitments? Is water demand best incentivised through separate performance commitments on business and household consumption and leakage or through a performance commitment measuring total demand?

Q5.2. Do you agree with our proposed guidance for bespoke performance commitments?

Standard incentive rates

Q5.3. Do you agree with our proposed approach to setting standard rates?

Q5.4. Do you agree with our proposed approach to the measures of experience performance commitments, including to increase the size of C-MeX?

Q5.5 Do you agree with our proposed approach to estimating marginal benefits for common and bespoke performance commitments?

Q5.6. Do you agree with our proposed approach to incentivising asset health performance?

Enhanced incentives

Q5.7. Do you agree with our proposal to retain, expand and streamline enhanced incentives?

Q5.8. Do you agree with our proposed approach to selecting performance commitments for enhanced incentives?

Q5.9. Do you agree with our proposed approach to setting enhanced thresholds, rates and caps?

Q5.10. Do you agree with our proposed approach to knowledge sharing?

Assessing and managing risks

Q5.11. Do you agree with our proposal to set caps and collars on a targeted basis, and apply a two-sided aggregate sharing mechanism to all companies?

Q5.12. Do you agree with our proposal to not set deadbands on any performance commitment?

Q5.13. Do you agree with our proposed approach to estimating ODI risk?

Incentivising outcomes beyond PR24

Q5.14. Are there instances where providing greater clarity over our intended approach to incentive rates in PR29 would clearly be in the interests of customers? Please explain why and provide supporting evidence.

Implementing payments

Q5.15. Do you have any comments on our proposed approach to implementing and streamlining payments at PR24?

Q5.16. Do you have any wider comments about the ODI framework at PR24?

Ch6 – Setting expenditure allowances

Providing companies with an efficient cost allowance

Q6.1. Do you agree with our proposed approach to setting efficient expenditure allowances at PR24?

Q6.2. What are your views on how we can best align the treatment of third-party costs and revenues?

Q6.3. Do you agree that companies that submit the most stretching and well evidenced business plans should receive the most favourable cost sharing rates at PR24?

Funding for water companies to maintain good asset health and resilience

Q6.4. Do you agree that resilience enhancement should be used to fund companies to manage increasing risks to specific hazards that are beyond their control and not covered by base expenditure and other enhancement areas?

Delivering service improvements to customers and the environment from expenditure allowances

Q6.5. Do you agree with our proposed approach to setting performance commitment levels at PR24?

Q6.6. Do you agree with our view on what performance commitments should be set using common or company specific performance commitment levels?

Facilitating efficient investment over 2025-30 and the long term

Q6.7. Do you agree with our proposed approach to incentivising and funding efficient investment in reducing greenhouse gas emissions and reducing the use of storm overflows?

Q6.8. Do you agree with our proposed approach to implementing nutrient neutrality in the PR24 regulatory framework?

Delivering best value

Q6.9. Do you agree with our proposed approach to encouraging companies to deliver best value through our cost assessment?

Q6.10. Do you agree with our proposed approach to removing the potential disadvantage that nature-based operating expenditure solutions may face in relation to the treatment of enhancement operating expenditure?

Ch7 – Aligning risk and return

Q7.1. Do you have any comments on our approach to the overall balance of the PR24 incentive package, our proposed guidance on producing risk ranges, and our view of the balance of risk facing the notional company?

Q7.2. Do you agree with our proposals on the regulatory regime for managing companies' exposure to uncertainty over 2025-30?

Q7.3. Is there value in introducing more prescriptive requirements and guidance for company-produced RoRE risk ranges? How might this be implemented for:

a. Interactions between performance on cost and service?

b. Interactions between performance on different ODIs?

Q7.4. Do you agree with our proposed approach to setting the allowed return on equity?

Q7.5. Do you agree with our proposed approach to setting the allowed return on debt?

Q7.6. What are your views on the options we have set out for estimating the RPI-CPIH wedge for converting RPI-linked yields to a CPIH basis?

Q7.7. Do you agree with our proposed approach to the notional structure and setting allowances for corporation tax?

Ch8 – Financeability

Q8.1. Do you agree with our approach to assessing financeability?

Q8.2. Do you agree with the focus on the metrics outlined in section 8.4 for the assessment of financeability?

Q8.3. Do you agree with our proposed approach to cost recovery, in particular that we set a narrow range for RCV run-off rates within which companies will be required to evidence their choice of rate which best achieves a fair balance between current and future customers?

Ch9 – Promoting financial resilience

Q9.1. Do you agree with the proposed standard set of scenarios for testing financial resilience?

Q9.2. Do you agree with our approach to how the board of the company should approach its board assurance statement?

Q9.3. Do you agree with our proposed approach to dividend policies, performance related executive pay and voluntary sharing of financial outperformance?

Ch10 – Companies' PR24 submissions

Q10.1. Are the PR24 submission requirements clear and sufficiently specified?

Q10.2. Is any data missing, or included but not required or areas we need to look at again?

Q10.3. Are the limits on the number and size of documents workable? Should we be more prescriptive in terms of file and folder structures etc?

Q10.4 Do our expectations for company board's assurance and governance arrangements provide enough guidance to ensure that boards have sufficient level of 'ownership' and so ensure a high quality submission?

Q10.5. Do you agree with our proposal to continue to apply revenue adjustments for past performance across all years of 2025-30, after the financeability assessment?

Bioresources specific questions

Q10.6. Do you have any comments on how to best deal with the impact of shadow and non-shadow reporting in table BIO3 on other tables?

Q10.7. Do you have any comments on the data we should collect in table BIO5?

Ch11 – Encouraging quality and ambitious business plans

Q11.1. Do you agree with the framework we propose to encourage the best business plans? Specifically, do you agree

- that we should first assess 'quality' followed by 'ambition'?
- with our proposed allocation of rewards and penalties for performance on each?

Q11.2. Do you agree with the proposed scope of our 'quality' assessment? Specifically, do you agree:

- we should have minimum expectations in the six areas described above?
- with the minimum expectations we specify in each of the six areas?

Q11.3. Do you agree with the proposed scope of our ambition assessment?

Q11.4. Do agree with our proposed reputational, financial and procedural rewards and penalties, including the overall package of reward and penalty?

Q11.5. Do you have any other comments regarding our proposed approach to business plan incentives at PR24?

Appendix 4 – Bioresources control

Questions on this appendix have a separate response date of 5pm Friday 16 September 2022. Please email your response to: alexandros.maziotis@ofwat.gov.uk and CostAssessment@ofwat.gov.uk.

Appendix 6 – Performance Commitments

Customers receiving excellent service every day

QA6.1. Do you have further views on whether the proposals laid out for C-MeX are appropriate?

QA6.2. Do you agree that C-MeX needs to adapt to provide better service to vulnerable and worse served customers?

QA6.3. What are your views on our proposal to introduce a single, combined common performance commitment ('BR-MeX') capturing the experience of both end business customers and retailers as intermediate customers?

QA6.4. Do you consider evidence suggests that the current water supply interruptions performance commitment is inhibiting innovation? If so please provide it.

Environmental

QA6.5. Do you agree with our proposed definition for the biodiversity performance commitment?

QA6.6. Do you agree with our proposal to have separate operational greenhouse gas emissions performance commitments for water and wastewater, which are based on a normalised measure?

QA6.7. Do you agree with our proposal that the performance commitment on serious pollution incidents should only apply to water and wastewater companies?

QA6.8. Do you agree we should focus the bathing water performance commitment on the outcome that customers have received and should continue to develop an alternative definition to do this?

QA6.9. Do you agree with our proposal for the river water quality performance commitment to measure the reduction of phosphorus entering rivers?

Appendix 13 – Data and modelling

QA13.1. Do you agree with our proposed approach to mechanisms at PR24?

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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