# PR24 draft methodology

# Setting expenditure allowances webinar

13th July 2022

Ofwat

# Agenda

| Item | 14:00 to 15:15 |
|---|---|
| Introduction | 14:00 to 14:05 |
| 1. Setting efficient cost allowances | 14:05 to 14:35 |
| 2. Funding for water companies to maintain good asset health and resilience | |
| 3. Delivering performance improvements from expenditure allowances | |
| 4. Facilitating efficient investment over 2025-2030 and the long term | |
| 5. Delivering best value | |
| Consultation questions and timeline | |
| Q&A | 14:35 to 15:15 |

# Introduction

The purpose of this webinar is to provide an **overview of our proposed approach** to setting expenditure allowances at PR24

Further information on our proposed approach is published in **Chapter 6 of our consultation document** and Appendix 9 – Setting expenditure allowances

There will be an opportunity for questions at the end of the webinar. The purpose of the question and answer session is to **provide clarification** on our proposed approach to setting expenditure allowances at PR24. The purpose is not to debate our proposals

We are recording this webinar, primarily to help us to draft minutes of the discussion. But it may be shared with Defra and the Welsh Government

Please ensure you are on mute, and **we ask that questions are submitted via the chat function** to ensure all companies have an equal opportunity to ask questions

We encourage you to ask as many of your clarification queries as possible in this webinar. If there are any that occur to you later, you can send them to the PR24 inbox (PR24@Ofwat.gov.uk) before 4 August 2022 so that we can answer them before consultation responses are due on 7 September 2022

# 5 principles underpin our proposed approach to setting expenditure allowances:

1. Provide companies with an efficient cost allowance so that customers do not pay more than they need to
2. Allow sufficient funding for water companies to be resilient and maintain good asset health
3. Companies must deliver improved service to customers and the environment from expenditure allowances
4. Facilitate efficient investment over 2025-30 and the long term
5. Encourage companies to deliver best value. This requires companies to take account of wider environmental and social benefits, costs, risks and affordability of customers' bills when developing enhancement proposals

# 1. Providing an efficient cost allowance

## Setting efficient base cost allowances

- We propose to build on our PR19 base cost models, making improvements where appropriate
- We intend to publish an updated base cost dataset in autumn 2022, and ask companies to submit their own proposed cost models in early 2023
- We aim to publish a base cost modelling consultation in spring 2023, which will provide an early view of our PR24 base cost models

## Setting efficient enhancement cost allowances

- We propose to make greater use of enhancement cost benchmarking, including the use of outturn costs and cost drivers and information from industry databases and expert cost consultants
- We propose to use four assessment criteria groupings to assess enhancement expenditure at PR24: need for enhancement investment; best option for customers; cost efficiency; and customer protection.

## Cost adjustment claims

- We propose to focus cost adjustment claims on base (wholesale and retail) and bioresources costs
- We expect companies to submit compelling evidence against the assessment criteria
- We expect companies to submit symmetrical cost adjustment claims where the claim relates to costs incurred historically and subsequently included in our modelled cost baseline
- We propose an early cost adjustment claim submission and publication in summer 2023, which will allow all companies to consider these in their PR24 business plans

# 1. Providing an efficient cost allowance

## Setting a stretching but achievable efficiency challenge

- We propose to set separate catch-up and frontier shift efficiency adjustments
- A stretching but achievable cost efficiency challenge encourages lagging companies to catch-up with the leading companies in the sector at a fast pace (ie catch-up) and encourages leading companies to improve further (ie frontier shift efficiency)
- We intend to use a range of evidence to set the efficiency challenge, including efficiency evidence from the water sector and comparator sectors
- We will require compelling evidence for real price effect adjustments

## Cost sharing

- We propose to simplify our cost sharing approach, reducing the degree of asymmetry in cost sharing rates
- The table below summarises our proposed cost sharing rates across the four business plan categories

| Business plan category | Overspend rate | Underspend rate |
|---|---|---|
| Outstanding | 50 | 50 |
| Standard | 50 | 50 |
| Lacking ambition | 55 | 45 |
| Inadequate | 60 | 40 |

# 2. Funding for water companies to maintain good asset health and resilience

We expect companies to provide resilient services for customers today and over the long term

Customers expect continuous water and wastewater services, and disruptions can have a significant impact on customers and the environment

We fund companies to be resilient over the long term through a combination of base and enhancement expenditure. Much of the expenditure to maintain resilience is through base expenditure allowances

Our historical allowances have been sufficient for companies to maintain and improve outcomes and asset health metrics over previous periods

## Reflecting forward looking pressures in our base expenditure allowances

We propose to include more of a forward look in our base cost models, by considering:

- additional cost drivers, such as on sewage treatment complexity;
- using forecast cost data in our base cost models (if appropriate); and
- cost adjustment claims where these are supported by compelling evidence

## Investment to improve resilience

We propose to revise our definition of resilience enhancement expenditure to focus on increasing risks from hazards not covered by base costs and other enhancement areas

Example hazards include source water pollution, fluvial flooding of company assets and mitigating failures of other infrastructure systems such as power networks

We also provide further clarity on our expectations for resilience enhancement claims

# 3. Delivering service improvements to customers and the environment from allowances

The future service companies pledge to deliver are quantified through performance commitment levels (PCLs)

We expect companies to identify stretching but achievable PCLs in their business plans

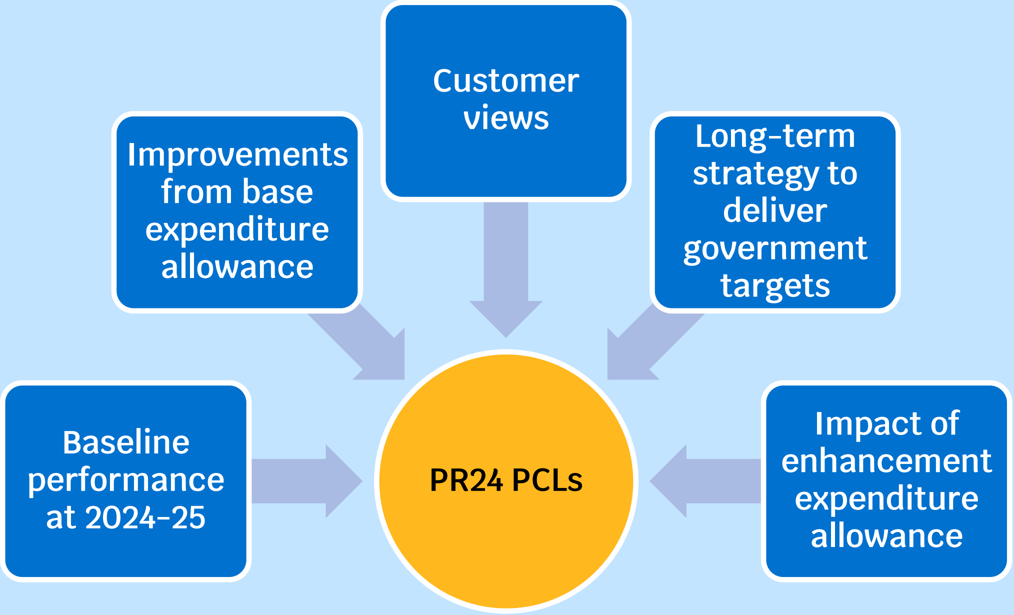
We also expect companies to challenge themselves on what they can deliver through base allowances

We have developed four key principles for determining the performance levels an efficient company can deliver through our efficient expenditure allowances:

1. **We will consider if companies should be expected to deliver a common or company-specific level of performance for each performance commitment**
2. **We expect efficient companies will continue to improve performance over the long term from base expenditure**
3. **We will consider the overall stretch across cost and service and account for the performance of efficient companies when setting PCLs**
4. **We will adjust PCLs to account for enhancement expenditure where necessary**

Our proposed approach to setting PCLs is summarised in the figure below

We expect companies to take account of our approach when developing their long-term forecasts of the performance improvements they can deliver



# 4. Facilitating efficient investment over 2025-30 and the long term

## Planning needs and outcomes over the long term

- We expect long-term delivery strategies to form a key part of the evidence for enhancement expenditure for PR24
- Companies should propose low and no regret investments, which are phased, flexible and minimise low utilisation enhancements
- We expect companies to reflect our comments on WRMP, DWMP, WINEP for England, and NEP for Wales in PR24 business plans
- We support a move towards a more outcomes-focused WINEP/NEP. Under this approach we set the outcomes we expect companies to deliver with efficient allowances

## Facilitating efficient long-term investment

We propose to encourage long-term delivery by providing:

- greater clarity on how we will handle multi-period investments;
- funding for preparatory work for uncertain & long-term options;
- continued funding for the development of strategic water resource solutions; and
- continued transition funding

## Ensuring delivery over the long term

- We propose that companies include price control deliverables (PCDs) for all enhancement schemes where the impacts are not fully covered by outcome delivery incentives in 2025-30

## Nutrient neutrality

- We propose to allow funding through the price review if water companies are required to go beyond environmental requirements due to nutrient neutrality in England
- We expect developers to pay the full costs for any nutrient mitigation

# 4. Facilitating efficient investment over 2025-30 and the long term

## Delivering long-term targets quickly and efficiently

$CO_2$

- **Net zero** – Expect continued reductions in greenhouse gas emissions through base and enhancements on glidepath to net zero by 2050. Supplemented by additional net zero specific enhancement spending and a net zero challenge

- **Storm overflows** – All companies to meet 20 average spills by 2025 (and beyond if legal obligations require) and make further reductions across the 2025-30 period through base expenditure allowances. Companies can go further than indicated by PR19 investigations – focusing on environmental harm from high priority overflows

- **Water demand** – All companies to make progress towards the UK government target of 50% leakage reduction by 2050, either individually, or collectively. All companies to plan to meet the UK government target for personal water consumption of 110 litres per person per day by 2050 and English companies to reduce distribution input per head of population by 20% by 2037

- **Phosphorous removal** – New river quality performance commitment will encourage companies go beyond reductions in WINEP/NEP.

# 5. Delivering best value

We are proposing to support companies delivering best value over the 2025 to 2030 period, where this is efficient and affordable to do so. We will do this by:

## Accounting for wider economic benefits

- We propose to take account of wider environmental and social benefits more robustly and widely in our assessment of enhancement expenditure proposals
- Benefits that influence most the choice of enhancement solution need to be measurable and robustly demonstrated

## Facilitating the use of nature-based solutions

- We propose to provide greater surety of funding for nature-based solutions which are wholly or primarily based on ongoing operating expenditure
- If issues can be overcome, we are keen to support the capitalisation of operating expenditure
- Alternatively, we could set a 10-year operating expenditure allowance

## Encouraging companies to collaborate with others and maximise co-funding opportunities

- Where there are material benefits to third parties, we expect companies to proactively seek contributions from these parties. The size of these contributions should be in proportion to the benefits that third parties can expect to receive through the scheme (in line with our public value principles)
- To encourage companies to maximise co-funding opportunities, we propose to take account of third-party contributions in our benchmarking of enhancement expenditure

# Consultation questions

## Providing companies with an efficient cost allowance

1. Do you agree with our proposed approach to setting efficient expenditure allowances at PR24?
2. What are your views on how we can best align the treatment of third-party costs and revenues?
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

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

5. Do you agree with our proposed approach to setting performance commitment levels at PR24?
6. Do you agree with our view on what performance commitments should be set using common or company specific performance commitment levels?

# Consultation questions

## Facilitate efficient investment over 2025-30 and the long term

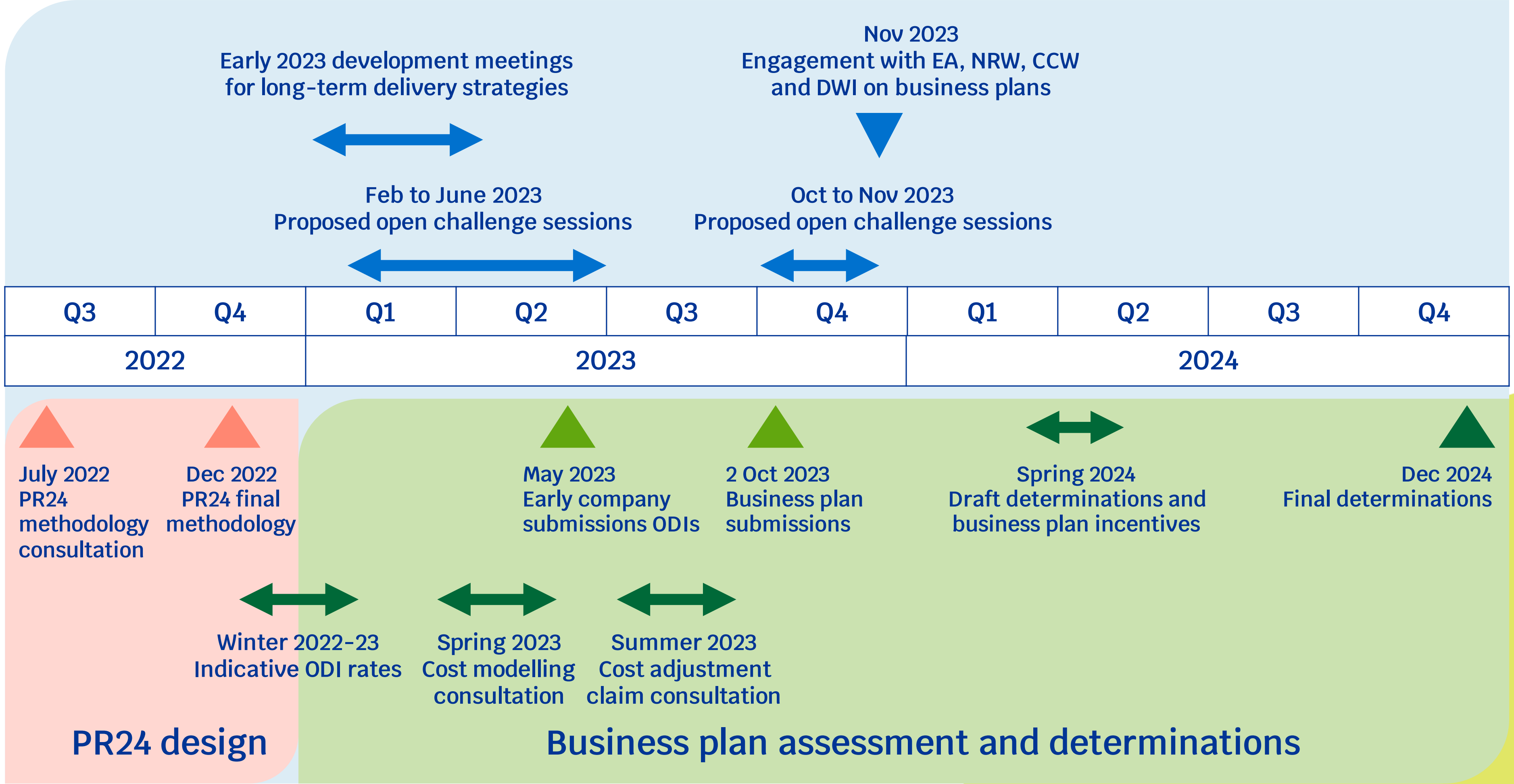
7. Do you agree with our proposed approach to incentivising and funding efficient investment in reducing greenhouse gas emissions and reducing the use of storm overflows?
8. Do you agree with our proposed approach to implementing nutrient neutrality in the PR24 regulatory framework?

## Delivering best value

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

# PR24 timeline and next steps

## Consultation responses to our draft methodology proposals are due 7th September @ 5pm



# Thank you and questions