

December 2022

Creating tomorrow, together

Our final methodology for PR24

Foreword and
executive summary

ofwat

Transforming the water sector



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

The sector is facing significant challenges and expectations have risen – customers, regulators and Governments are clear that change is needed: greater resilience to drought, significantly better outcomes for the environment and more responsive services for customers.

People question why hosepipe bans are needed when leakage is high. And they are concerned at the overuse of storm overflows – there are new standards that the sector needs to meet. Some of the challenges relate to our changing world. Climate change is not new, but the need for sustained action is clearer than ever.

Improving performance

The sector faces challenges because of how it performs. All companies have a number of obligations that are non-negotiable; they must deliver on them. If companies fail to deliver, we step in.

Ofwat's recent enforcement actions against Thames Water and Southern Water resulted in £257 million of financial penalties and rebates to customers, and significant changes in how they deliver for customers and the environment in the future. We are currently investigating compliance with various legal obligations by all wastewater companies in England and Wales, including in relation to the operation of their wastewater treatment works. We will not hesitate to act if we find companies have breached their obligations.

Customer service needs to improve as too often companies fail to get the basics right. Our research, jointly with CCW, into customers' experience of company responses to sewer flooding in their homes, highlighted the improvements that are needed. Even the best in the water sector fall short of service in other sectors and there is no excuse for water customers to get second best.

The sector also needs to act now – in advance of PR24 – where it is not doing enough. Significant improvements are still needed to drive down water demand, minimise supply interruptions and reduce pollution incidents. Companies are funded to deliver good quality services, and they need to improve areas of poor performance. In this context, it is disappointing that companies have spent only 68% of their enhancement cost allowances for the 2020 to 2022 period. Companies should be using this funding to deliver improvements quickly.

Rebuilding public trust

Companies need to recognise that the public's trust in them has been shaken as investors and executive teams appear to be rewarded despite companies failing customers and the environment.

Ofwat has asked companies to ensure that dividends and performance-related executive pay reflect how well they are performing for their customers and the environment. However, companies still have a long way to go to on both issues. We are consulting on a licence change to strengthen company accountability on dividends and taking action on executive pay.

Companies can also rebuild trust by ensuring that they have the financial resilience to cope with disruption or turn around poor performance without further costs falling on their customers. We have consulted on a licence change to ensure all companies meet high standards of financial resilience.

Rapid progress needed

We share the public's concern about the need to see rapid progress on the operation of storm overflows. In response to Ofwat's challenge, several companies have made commitments to improve river water quality and substantially reduce storm overflows by 2025. Of course, all companies must meet their legal obligations and we expect them to at least match the most ambitious commitments made by the leading companies. We are also aware of the challenge of making long term improvements to river quality to meet the aspirations of customers and stakeholders and expect PR24 to take a big step forward to deliver on substantive improvements.

Stepping up further

This publication principally focuses on how the water companies will operate between 2025 and 2030 and beyond. But it is clear that there is a lot that needs to be done before the next price review takes effect.

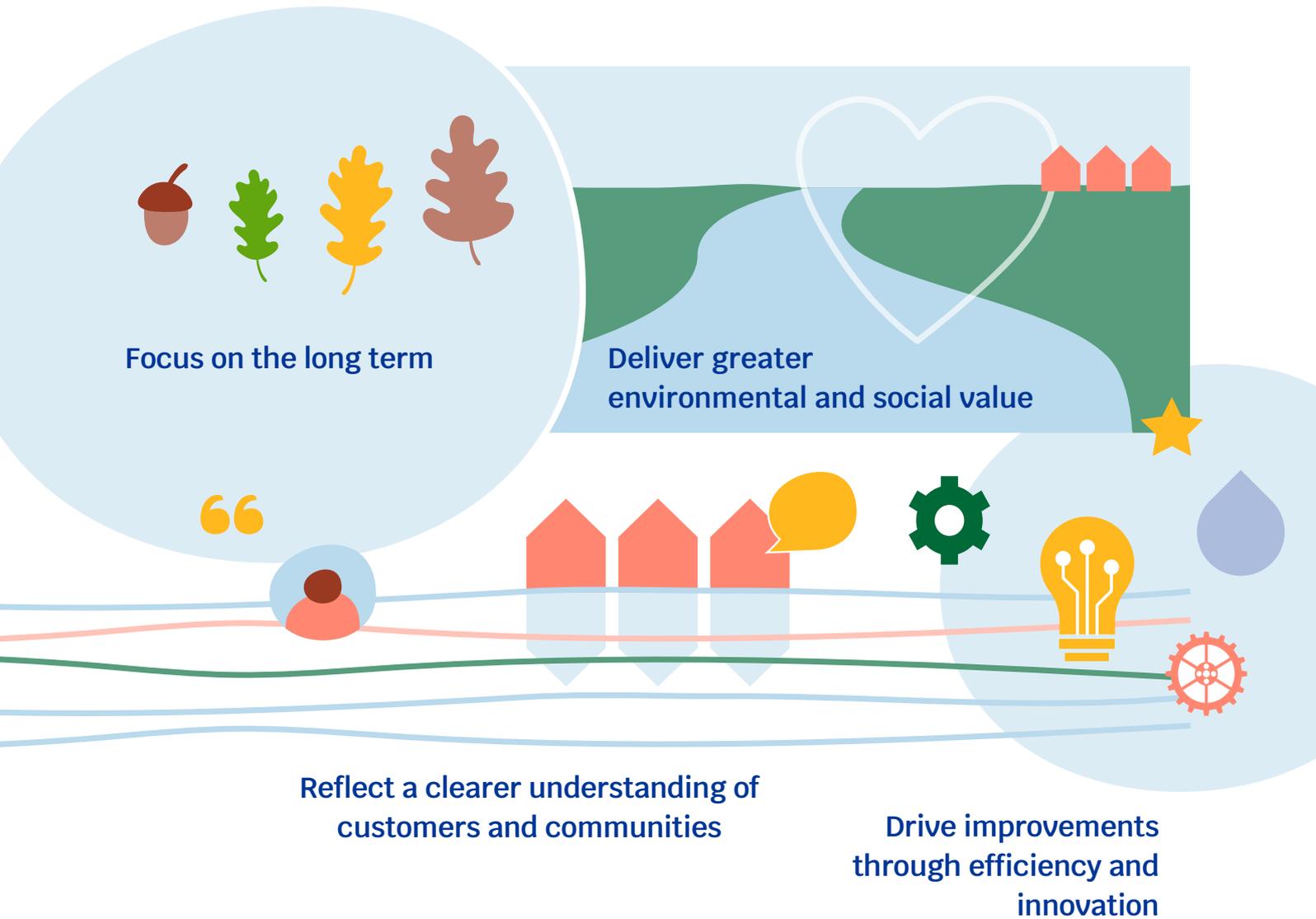
The sector needs to be in a stronger position so that it can innovate and step up further and deliver against new expectations at PR24. It must seize the opportunities to move forward and deliver the resilient services that everyone deserves and to reach higher to achieve more stretching levels of customer service and environmental stewardship.



David Black
Chief Executive

PR24: building a better future

Our methodology for PR24 sets out how we will drive companies to deliver more for customers and the environment. The methodology reflects our four key ambitions for the review:



More for customers and the environment



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 targets for the whole sector. And we will encourage companies to go further, with simple and powerful incentives to deliver better performance where it is in the interests of customers, communities and the environment.

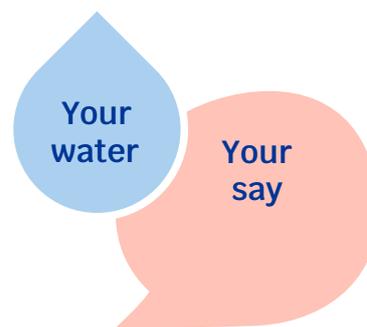
PR24 will focus on the key outcomes that matter into the long term for customers and the environment. We will incentivise companies to deliver excellent customer service, protect and enhance the environment, and to maintain and improve the health of their assets.

We will build on the measures of customer experience introduced at PR19 to drive up standards for residential, business and developer services customers. There needs to be a step change in customer service levels and we will increase the financial incentives to drive this change.

We are introducing a broader range of environmental commitments including on the use of storm overflows, eliminating serious pollution incidents, improving biodiversity, improving bathing water quality and delivering reductions in greenhouse gas emissions. PR24 will incentivise companies to maintain and improve asset health, and we will drive a greater focus on asset stewardship for the long term alongside action in the price review.

Listening to customers

Companies' business plans need to reflect the expectations of customers and communities for the services and benefits the company will deliver, and the costs of those services. Our ambition is that residential and business customers', and the wider community's, voices are heard more directly and more effectively in PR24 than ever before.



We are ensuring that there is robust research to reveal customers' relative priorities and views on the outcomes that companies need to deliver. And we are requiring companies to hold two 'Your water, your say' meetings, which provide an opportunity for customers, and for community and wider stakeholders, to challenge companies on their plans directly in an open forum.

Driving ambition and innovation

We expect companies to propose stretching targets, and to be responsive to wider expectations. PR24 will reward ambitious plans, and there are opportunities for companies to lead the sector – our approach will reward companies that go much further and faster to meet customers' expectations on key outcomes.

Innovation will be key. On leakage, for example, companies will be rewarded if they can set and deliver aggressive reductions. We expect companies to embrace the opportunities to improve performance through smart technology and better use of data.

We have also set a net zero challenge that will ensure that the sector as a whole makes the most progress at least cost.

More generally, companies need to help their customers to use water more efficiently – average water consumption in England and Wales is currently 146 litres per day, compared with a target of 110 litres per day. PR24 will introduce a fund of up to £100 million to help stimulate a transformative, sustained and measurable reduction in water demand nationally, using a range of water efficiency approaches.

PR24 will continue to push companies to work innovatively to achieve more. We will incentivise companies to work in partnership with others where appropriate to deliver better outcomes for customers and the environment. We will continue to use development funding to drive more progress on the delivery of strategic water resource solutions.

In 2020 we launched our £200 million Innovation Fund to support initiatives which bring significant benefits for customers, communities and the environment. We look forward to seeing the successful innovations being rolled out by companies in the PR24 period. And we will extend our Innovation Fund to provide at least £300 million to support further sector-changing ideas and ways of working at PR24.

Long-term improvements



Delivering against higher expectations will require major new investments. This will create upward pressure on bills over and above the impact of inflation. It is vital that companies plan and deliver best value solutions.

Our approach in PR24 will mean that customers' money can be spent well to deliver what is needed over the long term. Funding will support efficient enhancement investment, both in the short and long term.

We are requiring companies to set their five-year business plan in the context of a 25-year long-term delivery strategy. Companies need to plan over the long-term and we expect them to use adaptive planning to identify what needs to be done in 2025 to 2030 and what decisions should be scheduled in future periods when there will be greater certainty. This will lead to a clearer focus on the long-term needs of customers and the environment and better decision-making on how those needs are met.

These delivery strategies will focus on the long-term improvements needed, in line with the priorities set for Ofwat by the UK and Welsh Governments. And the review will challenge companies to deliver efficiently across their plans. We will allow customers' money to fund only the efficient costs of providing services. Where significant new investments are identified, we will ensure that customers don't pay if companies fail to deliver.

Our approach enables companies to invest now in improvements that will benefit future generations. PR24 will steer companies more firmly to ensure that the costs of these improvements are shared fairly between current and future customers. Companies are also incentivised to propose voluntary sharing of benefits with their customers, and to identify innovative ways to support customers who struggle to pay their water bill.

The role of investors

Investors have a key role in providing the finance necessary for companies to deliver their activities – it allows new investment in PR24 to be recovered over the long term. The returns investors earn will depend on the performance of companies as well as reflect the risks they take and the level of investment. These returns are ultimately paid for through customers' bills – so ought to be no more than necessary to attract investment to the sector.



We have set out our methodology for determining the allowed return on capital. Two years ahead of final determination, we have provided an early view of the allowed return, which is 3.29% (in real, CPIH terms). This is above the allowed return set at PR19, reflecting changes in interest rates. Our early view figure illustrates the application of our methodology and provides a number for companies to use in their business plans. We will use our methodology to set the allowed return in draft and final determinations reflecting market data at the time. However, we may index a component of the allowed return on equity if the recent levels of market volatility persist.

Companies and investors will earn rewards for delivering more of what customers and the environment want and need, and where they can innovate to drive down their costs further. Where they fall short of customer expectations, then returns will be reduced. The potential for much greater investment will bring greater opportunities for those companies that can deliver and perform well.

Dividends which reflect performance

We expect companies to set out their proposed dividend policies for 2025 to 2030, ensuring that they take account of company performance in delivering obligations and commitments to customers, communities and the environment, and long-term financial resilience. We also expect companies' performance-related executive pay arrangements to reflect stretching delivery for customers and the environment and performance overall.

Using markets to deliver

We are using markets where that is most effective, reflecting the UK and Welsh Governments' strategic priorities. We are requiring companies to use the Direct Procurement for Customers approach for all discrete projects over £200 million as this approach can drive down costs while maintaining quality. And we are reducing the regulation for developer services in England to reflect growing competition, and introducing pro-market reforms to the bioresources market in order to drive better outcomes for customers and the environment.

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

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA
Phone: 0121 644 7500

© Crown copyright 2022

This publication is licensed under the terms of the Open Government Licence v3.0 except where otherwise stated. To view this licence, visit nationalarchives.gov.uk/doc/open-government-licence/version/3.

Where we have identified any third party copyright information, you will need to obtain permission from the copyright holders concerned.

This document is also available from our website at www.ofwat.gov.uk.

Any enquiries regarding this publication should be sent to mailbox@ofwat.gov.uk.