PR24 – Making it all add up

A slide deck for Bristol Water/South West Water

August 2022

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The purpose of this slide deck

The PR24 Draft Methodology is underpinned by two key "philosophies":

Strong high-level and largely symmetrical incentives

- Key examples:
  - Wide RoRE range on ODIs and reward-only enhanced incentive rates
  - +/- 30bps business plan incentives
  - Totex sharing rates
- Ofwat describes the incentives as symmetrical – this will only be true if the efficient company has an equal chance of out- and underperformance

Standardisation and prescription

- Key examples:
  - Discouraging and limiting bespoke measures
  - ODIs set by Ofwat using limited evidence base
  - Common PCLs set for many measures based on base expenditure
  - "Quality" aspect of business plan incentive means that companies need to accept ODIs, WACC, PAYG, run-off rates, uncertainty mechanisms, etc.

- From Ofwat's point of view, this could be a sensible combination as it can demonstrate to stakeholders that it is tough, has simplified the process, potentially reducing the costs of regulation while maintaining strong high-level incentives
- However, the current way of implementing and calibrating the balance between the two features is unlikely to achieve a sensible price control outcome
- The objective of this slide deck is to articulate why there is a high risk that the combination of the two features in the current draft methodology could lead to a price-setting process and outcomes that does not deliver for customers, stakeholders and the environment
- Our analysis is conceptual and is based on our high-level assessment of Ofwat's published draft methodology for PR24, further analysis could be undertaken to confirm the assessment

Our hypothesis and case for a changed approach

Risk and consequence

There is **a risk that company-specific information and data will be ignored or lowly-weighted** by a standardised process.

As a consequence, incentives may look like they are symmetrical but in reality companies will face very diverse risk profiles. Stakeholders could be misled and companies may get incentives to focus on areas where the customer benefits are, in reality, limited.

There is a risk that Ofwat will apply a **high-level methodology to all companies based on a notional/efficient company, without allowing for diversity of strategic context.**

If this is the case (or is what companies expect) companies' strategic choices are limited to:

1. Prepare a "Ofwat-consistent delivery plan" (if that is possible given environmental investment drivers etc); or.
2. Develop an individual plan that works for stakeholders, but has a high chance of being rated inadequate by Ofwat due to the minimum expectations for customer affordability and acceptability, outcomes and the risk and return assessment areas (and lead to CMA appeal).

The consequence for Ofwat from each company's strategic option are that:

1. Plans reveal limited information, are not innovative, not aligned with local stakeholders, but tick Ofwat's boxes
   – Post-PR24, the industry will increasingly focus on regulators and not on stakeholder needs, the regulatory relationship becomes parent/child, risk of group think
2. Plans reveal useful information, are innovative, aligned with local stakeholders but companies may need an in the round review via CMA
   – Post-PR24, industry/regulator trust reduces and relationships are antagonistic

How Ofwat can still address this risk

Ofwat can still mitigate against this risk by having more and better processes for taking company information (e.g. on RoRE range and on customer priorities) into account

Ofwat can adapt its approach to mitigate against this. Key areas for change include:

- Tweaks in costs and outcomes to allow for company-specific approaches to balance risk and reward – e.g., targeted cost sharing rates by investment driver, deadbands, caps and collars on ODIs, notified items
- Business plan incentives recalibrated to promote credible plans that do the right thing for stakeholders:
  - Remove the apparent potential for a plan diversity penalty through the quality assessment – this could be achieved in a number of ways, including by removing the gated quality assessment and considering plan credibility within the overall assessment
  - Reframe the ambition assessment to be about risk – i.e., well-constructed plans have balanced risk and reward appropriately to their individual strategic context, ambitious plans accept more risk and (if credible) gain more reward potential. Plans considered too cautious for their circumstances can be adjusted by Ofwat through tougher outcome targets/efficiency challenges in the usual way
  - Company Boards state whether and how they have balanced risk or accepted more risk (for reward)
- Board/Ofwat meetings to explain plans in advance of submission/reintroduction of initial assessment

The remainder of this slide deck gives evidence in support of this overall hypothesis

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PR24 standardisation reduces the opportunity to balance and manage diverse risk profiles

Ofwat's RoRE range is based on a notional/efficient company

- In assessing its notional RoRE range, Ofwat has to make many underlying assumptions.
- These assumptions go beyond just the notional financial gearing. For example:

Relative equity weighting of different price controls and of new obligations	
Cost of embedded debt	Proportion of index-linked debt
Ratio of new totex to current RCV	Pension deficit obligations

- It also assumes that future risks can be estimated using limited ranges of past industry performance.

There are a number of legitimate reasons why individual companies' RoRE ranges will differ from this….

- Companies own RoRE will be different to Ofwat's notional efficient range in 3 ways.

P50 may be below/above Ofwat's intended level	The range may be skewed towards the upside/downside	The range may be wider/narrower than Ofwat expects

…. beyond gearing there are three key causes of this diversity

1	2	3
Diverse strategic context at 2025	**Diverse strategic context beyond 2025**	**Legacy inefficiency**
Inherent diversity between companies, e.g. balance between wholesale/retail controls, size of RCV compared to MEAV (historical investment requirements), cost of embedded debt efficiently incurred, pension liabilities	*Forward-looking diversity between companies, e.g. size/uncertainty of environmental investment requirements, changes to stakeholder/customer expectations/priorities, changed affordability constraints*	*Least important from a policy perspective in this context, beyond an understanding that this cannot be solved immediately*

Standardisation of the methodology reduces companies' ability to take any of these company-specific factors into account

- In previous price controls, companies/Ofwat were able to use a number of tools to reflect diversity of strategic context in business plans/determinations to allow adjustment to upside and downside risks to protect both companies and customers - This could reflect each companies' own strategic context, the wishes of local stakeholders and ensure ongoing financial and operational resilience.
- The standardisation in approach at PR24:
  - reduces the opportunity for company Boards to take these factors into account in their plans for fear of failing on "quality" or "ambition"…
  - … while the sharpening of incentives in general is likely to increase the potential consequences for customers and companies of imbalanced determinations.

Both companies and Ofwat may find themselves without the regulatory tools to address the key issues – a risk that either these real risks are not exposed at all, or that companies feel obliged to set-out on a "non-compliant" course in their plans

Companies choices on their plans are in many areas becoming more limited as PR24 increases the level of standardisation

Companies' choice ⟷ **Ofwat prescribed or standardised/statutory**

- Adaptive pathways and LTDS
- Enhancement expenditure for net zero
- Some degree of flexibility over some of the initial PCL levels in business plan submission (need to be aligned with ambition/base expenditure/future trends) – final PCLs set by Ofwat anyway
- Limited choice over bespoke PCs
- Social tariff assistance
- Voluntary sharing
- Base expenditure allowance largely determined by models that will be published early
- Acceptability testing
- Enhancement expenditure related to statutory drivers and frameworks such as WINEP, CSO targets, Environment Act, Nutrient neutrality, WRMP, DWMP – limited flexibility over timing
- RCV run-off/PAYG
- ODI rates
- PC caps, collars, deadbands
- WACC
- Cost sharing rates

PR24 leaves less room for company decisions

- Compared to PR19, the draft PR24 methodology is highly prescriptive without reducing its complexity
- Companies have little choice over key building blocks
- Initial plans have to "fit" into Ofwat's prescribed parameters and expectations (particularly over the minimum expectations for the "quality" assessment)
- Ofwat's "compelling evidence" hurdle not considered to be achievable in practice in the "one-shot game" plan assessment.

Indicates our sense of the direction of travel relative to PR19 methodology

Stronger high-level incentives and standardisation/prescription: Outcomes

Strong high-level (symmetrical?) incentives

- Smaller number of PCs and similar RoRE range as for PR19 means that ODI rates likely to be higher per unit (otherwise overall RoRE range will only be achieved by widening P10/P90 or via the removal of deadbands)
- Enhanced ODI rates likely to be twice the amount of standard rates and outperformance only
- Overall RoRE range discussed includes full exposure to +/- 3%, then 50% of sharing up to +/-5% and then 10% exposure beyond +/5% - this suggest that performance around +/-5% of RoRE on ODIs is possible and would signal wider range
- Removal of caps, collars and deadbands increases risk and ignores regulatory precedent set by the CMA
- Removal of reputational ODIs reduces the potential for innovation
- Removal of exceptions for weather and reduced scope for definitional changes mid-AMP in customers' interests
- Overall package likely to have stronger, sharper incentives

Standardisation and prescription

- Initial common PCLs set via base expenditure for 9 out of 21 PCs
- Full compliance expected for 2 out of 21 PCs
- Company-specific performance levels allowed for 6 out of 21 PCs
- 4 PCs are relative performance measures so do not need PCL
- Out of 17 PCs that need PCLs to bet set, more than 60% will initally be set at the common level
- Unclear how Ofwat will use base expenditure to set PCLs – most likely approach is to take company business plan PCLs and set common PCL at stretching level
- ODI rates set by Ofwat based on collaborative Marginal Benefit research that needs to be accepted to avoid *inadequate* business plan rating
- Enhanced ODI rates are no longer optional and will apply to four performance commitments

- Combination of strong high-level incentives and standardisation does not leave any room for companies to propose incentives that are aligned with their circumstances communities (their stakeholder and customer views) – areas of biggest change since PR19. The result of the methodology is an outcomes framework that is Ofwat-focused, not community focused
- Companies left with assessing the impact of the package

Stronger high-level incentives and standardisation/prescription: Costs

Strong high-level (symmetrical?) incentives

- Overall approach similar to PR19 (e.g. totex sharing rates) but efficiency challenge likely to be tougher as a result of:
  - 85th percentile efficient benchmark
  - Reflecting additional considerations such as innovation fund in frontier shift
  - Overall pressure from “what base buys“ concept means companies are expected to squeeze costs and improve performance at the same time

Standardisation and prescription

- Base cost models published in spring 2023 so companies can effectively calculate what their cost allowances at the 85th percentile efficiency challenge will be – while this simplifies the approach it also means that there is limited flexibility in considering actual costs
- Greater use of historical data to benchmark enhancement costs reduce ability to justify company-specific costs
- Symmetrical special cost factor claims reduce room for company-specific adjustments
- High evidential bar for notified items or othe risk-sharing approaches likely to be considered unachievable by companies in a one stage determination process

- Shift towards high-level incentives and standardisation/prescription not as big as for outcomes.
- However, early publishing of base cost models limits flexibility.

Stronger high-level incentives and standardisation/prescription: Risk and reward

Standardisation and prescription

- Notified items and uncertainty mechanisms are in theory allowable in a plan, but are subject to the “compelling evidence“ test which companies will not expect to win in any one-shot business plan process.
- Caps and collars could previously be used to limit company/customer exposure to outlier results with greater uncertainty in customer research, but their inclusion is now limited, while deadbands have been completed removed.
- Run-off rates and PAYG’s standardised, less opportunity to calibrate for affordability.
- Company-specific adjustments on cost of embedded debt allow for some non-standardisations (i.e. small company premium).

- Some standardisation and prescription with the setting of a high bar for companies to provide ‘compelling evidence’ and increases exposure to outlier risks in a one stage determination process

Stronger high-level incentives and standardisation/prescription: Business plan incentives

Strong high-level incentives

- +/-30 bps for different business plan categories, ranging from outstanding (+30bps) to inadequate (-30bps) with middle categories ranging from 0-+10bps (standard) to up to -30bps (lacking ambition)

Standardisation and prescription

- Two-stage process means that to avoid “Inadequate“ categorisation, companies need to pass Ofwat’s “quality” test so they need to accept a wide range of decisions, including:
  - ODIs
  - WACC
  - RCV-run off
  - PAYG
  - Ofwat’s standards for research, particularly for testing the affordability and acceptability
  - Etc

- Quality includes two aspects: 1. quality of the submission, e.g. Following guidance, accessible structure, etc and 2. accepting Ofwat’s specific assumptions. The latter is not a quality
- There is a high risk for the sector on RoRE-adjusted penalties each year and penalised cost sharing rates. Reflecting on Ofwat’s approach at PR19, it is possible that no company will be awarded the “outstanding” category.*

* No company was awarded the equivalent “exceptional“ rating at PR19. Only three companies were awarded the “standard“ category at PR19 (the equivalent of the “fast-track” rating).

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Here are four example scenarios/companies that each have a different ambitious strategy relevant to and related to their strategic context

Strong customer and stakeholder relationships

- A company could have strong relationships with local customers built up over the past decade
- Strong relationships with local stakeholders, including through social contract/benefit sharing
- Clear steer from customers and priorities that is not aligned with Ofwat/Defra direction of travel risks fracturing of relationships with local stakeholders and reduced legitimacy

Innovative approach to delivery

- A company may have a more innovative approach to delivery that is not conducive to top-down comparative benchmarking, for example, using an outcomes-based approach, maximising partnership working, etc
- This leads to more risk that cannot be captured anywhere in the prescriptive price control methodology

Focused on long-term benefits and public value

- A company may have a strategy to focus on long-term benefits and is therefore including investments such as smart metering or behavioural trials that are unlikely to deliver a step-change in performance in the short-run, creating additional ODI risk at PR24
- A company may be unsure on how a "best value" business plans is to be judged if robust valuations are not objectively clear. This could be because:
  - Robust valuations may be problematic for companies trying to abide by Ofwat's public value principles, given that such valuations are not necessarily economic, or will be determined by frameworks that themselves are open to interpretation and judgement

Legacy issues to be resolved

- A company may have specific legacy circumstances/assets that means it does not perform well in cost/service benchmarking

How would each respond to the business plan incentives?

	Response	Impact on RoRE
Strong customer and stakeholder relationships	▫ Choose a plan that ticks Ofwat's boxes or a plan that is aligned with customers and stakeholders? ▫ Risk that company will be in "inadequate" category vs local reputation/perception ▫ Valuable lessons for building close relationships not learned, disincentive to listen to local stakeholders?	▫ In worst case scenario, ODIs will not align with what customers want… ▫ … and therefore company will not deliver what it wants, but will have bigger ODI downside and smaller ODI upside
Innovative approach to delivery	▫ Choose to submit ambitious plan and risk under-funding or under delivery? How can the company articulate the risk profile/approach? ▫ What are the benefits from proposing an innovative approach? If perceived to be downside only, company will choose "low risk" plan and industry will not learn from innovative approach. Proposing a bespoke innovation ODI risks Ofwat judgement on quality/ambition.	▪ **Greater totex downside** in worst case scenario, as innovative solutions may not work and lead to capex/opex overspend/inefficiencies

How would each respond to the business plan incentives?

	Response	Impact on RoRE
Focused on long-term benefits and public value	▫ Choose to submit a plan that is aligned with long-term or focused on short-term performance? ▫ What are the benefits from including expenditure that does not pay off until the next price control? How much weight does the LTDS carry? If short-term focus is emphasised in final methodology, short-term plan more likely to be submitted at expensive of long-run and industry will miss out on learning	▫ In worst case scenario, greater ODI downside from underperformance in short-run ▫ In addition, greater totex downside if costs are disallowed.
Legacy issues to be resolved	▫ Choose between arguing the case or finding a short-term solution. ▫ There is only downside from making case as the prescriptive methodology does not allow for company-specific views in many areas. ▫ Risk that company will focus on finding short-term solution - Particularly relevant in the current policy context of ambitious investment and service expectations and wider public/stakeholder concerns.	▪ **Greater totex downside** in worst case scenario, due to risk of cost overruns

External pressures will also create diversity in risk and in how companies want to interact with the PR24 process

Large and/or uncertain environmental programme

- A company could have an enhancement programme that is well in excess of previous AMP periods and/or very high compared to others creating additional delivery risk and increased portfolio risk.
- The obligations themselves may be uncertain in terms of need and delivery date creating PCD and ODI risks.

Affordability issues

- The company may have much greater issues with income deprivation than others
- The impact of removing existing Social Tariffs and replacing with a national SST may be greater for a company with extensive use of deep discounts
- For SWW in particular, there could be uncertainty over the £50 government subsidy
- This creates additional cost (bad debt) risk, but also legitimacy and acceptability challenges

Changing stakeholder expectations for resilience

- A company‘s customer and stakeholders appetite for investment for operational resilience may have changed, perhaps driven by local events
- A company has identified a nascent operational resilience issue (e.g. from climate effects or security risk) that stakeholders require to be addressed urgently
- Dispersed solutions to improve resilience may not lend themselves to DPC-style approaches

Individual companies may face all, some, or none of the above external pressures

How would these diverse external pressures be reflected at PR24?

	Response	Impact on RoRE
Large and/or uncertain environmental programme	▫ Companies can expect to be penalised if they propose risk mitigations (e.g. IDOKs, adjusted cost sharing rates, gated processes) to rebalance additional delivery and portfolio risks. ▫ Company might instead redirect its remaining management resource into those PR24 ODIs where the standardised processes creates inconsistent outcomes – but unlikely to align with local priorities.	▫ Greater totex downside if costs are disallowed/overrun ▫ Greater ODI downside from underperformance
Affordability issues	▫ Retail totex challenge likely to be skewed to the downside but this will not be visible to stakeholders ▫ Company may legitimately wish to focus its plan's incentive framework towards cost-reducing benefits to customers (e.g. totex efficiency) rather than value increasing (ODI rewards), but risks being marked down for quality and ambition ▫ Company could benefit customers through challenging stakeholders on the need for/timing of environmental outputs, but PR24 provides limited incentives for it to do this	▫ Greater retail downside ▫ Greater ODI downside, if environmental targets set beyond what is affordable
Changing stakeholder expectations for resilience	▫ Choose a plan that ticks Ofwat's boxes or a plan that is aligned with customers and stakeholders? ▫ Risk that company will be in "inadequate" category vs local reputation/perception. ▫ Companies may be penalised if they propose risk mitigations (e.g. IDOKs, adjusted cost sharing rates, gated processes) to rebalance additional delivery and portfolio risks from the new local requirements.	▫ Greater totex downside if costs are disallowed/overrun ▫ Greater ODI downside from underperformance

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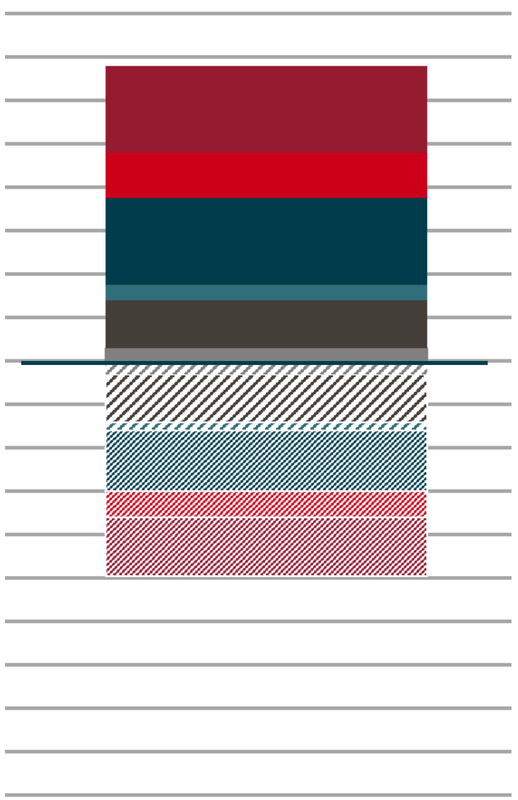
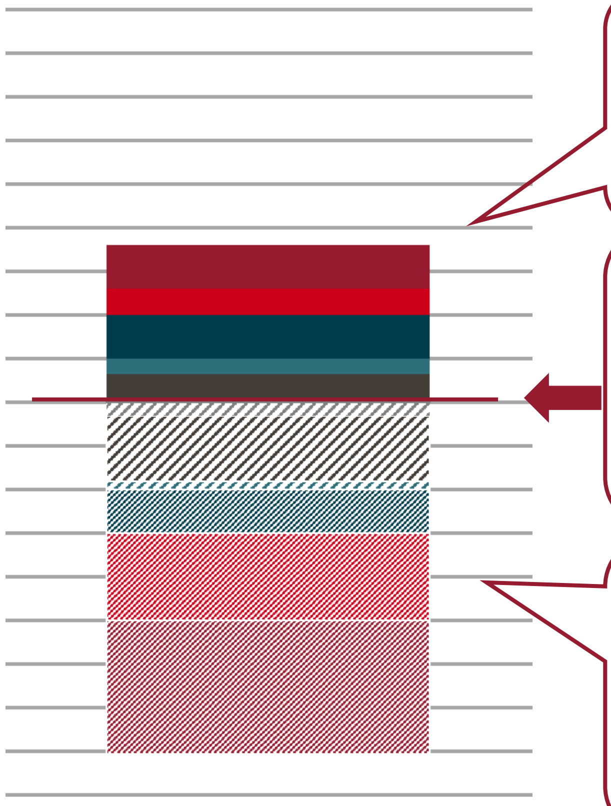
Making it all add up: Companies must translate Ofwat's standardised PR24 approach into their own actual strategic context

Ofwat view of a notional efficient company



Stylised potential reality of PR24 reflecting individual company strategic context, inherent at 2025 and future pressures.



Realistic outperformance much smaller

Companies' P90 achieves less outperformance than Ofwat's view of P90

Expected baseline return lower, as can't achieve targets

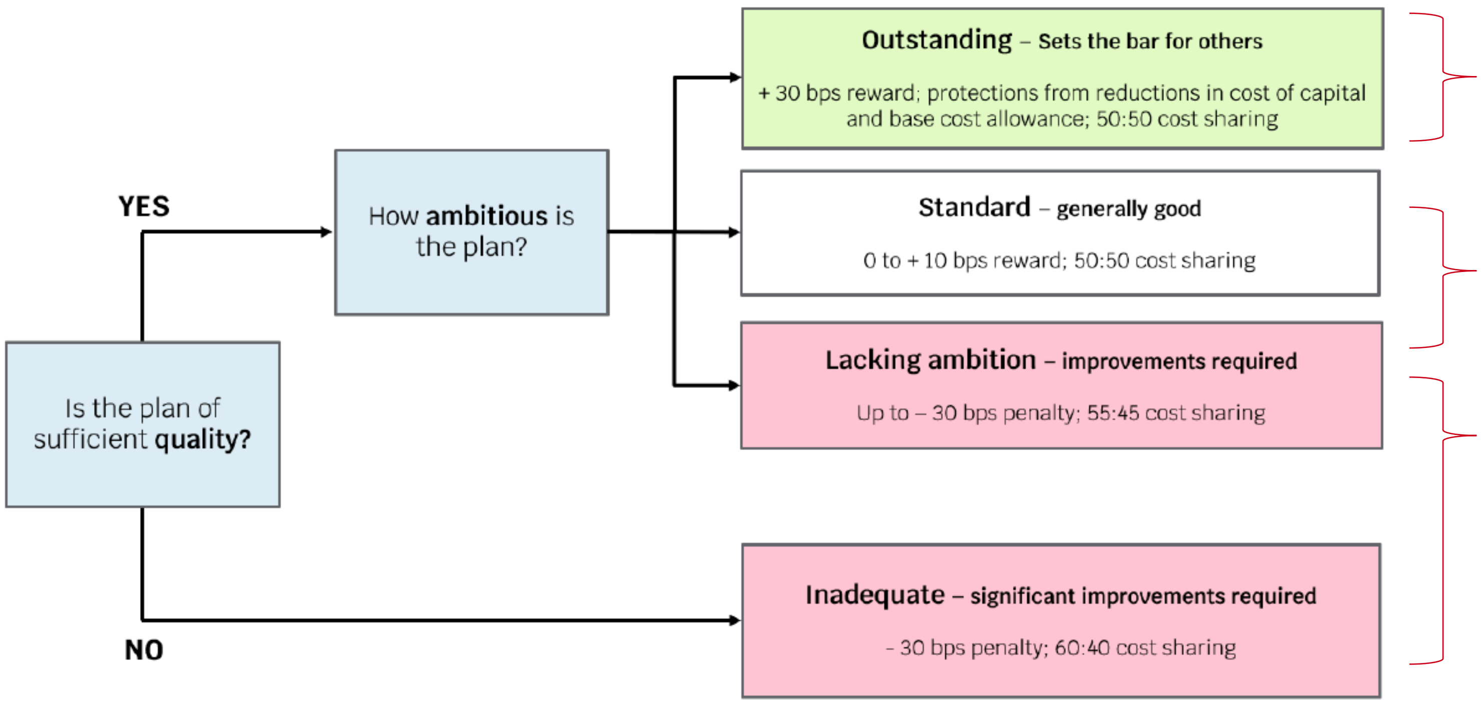
Companies' P50 achieves lower performance than Ofwat's P50

Realistic underperformance much larger

Companies' P10 achieves more underperformance than Ofwat's view of P10

- If this is all driven by company inefficiency, then this is not a problem as long as targets are achievable.
- However, if this is caused by justifiable differences in the strategic contexts faced by companies, then it may be appropriate to consider mitigations that rebalance risk.
- There may also be examples of strategic context that create upsides for companies (e.g. low enhancement requirement, different balances in activity and value between price controls with different levels of challenge applied).
- An inappropriate valuation for an ODI could give companies potential upsides that do not deliver true customer value in the long-run. Companies could choose to conform and exploit this.

Ofwat's business plan incentive framework means companies have a starker upfront choice on conforming with Ofwat standardisation...



This may not provide the right balance of incentives

- The business plan incentives set a high bar for companies in providing a quality (conforming) plan with a high penalty for not doing so….
- … which, given their own strategic contexts may not allow much room for companies to offer up anything more ambitious (even if they would like to).
- Some companies may judge a standard rating as achievable and worthwhile, even if their plan does not meet long-term stakeholder needs in their own context….
- … others may not perceive much difference between
  - the costs of delivering a plan that is sufficient quality but deemed to lack ambition…
  - … and a plan that is judged inadequate (i.e. does not conform), but which it considers is better focused towards its strategic context and on the needs of stakeholders in the long-run.

… & the decision-process companies face in responding to business plan incentives may limit the quality of Ofwat's information discovery…

1. **Develop best guess totex/PCL/bill impact**, taking into account statutory drivers, direction of travel for PCLs
2. **Add in key parameters needed to satisfy Ofwat's "quality" objective**

Key questions/considerations
Is the plan financeable?
Is it likely to land in at least the "standard" category for ambition?
Is it acceptable to customers/local stakeholders?
Is it deliverable? Appropriate level of risk?

What will the plan look like once Ofwat has made its assessment?

How does it change the answers to these questions?

No to all or some of the questions (even after iterations):

- Consider reputational and future legitimacy difference between "lacking ambition" and "inadequate" vs potential strengthen position at CMA appeal
- Identify key drivers and try to enter dialogue with stakeholders and customers
- What would alternative plan look like? Is there a version that works better for stakeholders, customers, the environment, long-run etc?

Yes to all – submit

Revise plan to try to achieve "standard"

Go for "own" plan and accept "inadequate" with view to appeal

Information discovery

Ofwat DD's

… and this may limit Ofwat's room for manoeuvre post plan submissions

In previous price controls Ofwat has been able to adapt its processes to information as it has been exposed through submissions

This relied on an expectation from companies that Ofwat would be willing to accept trade offs "in the round" that allow for a balanced plan and considering a wide evidence base.

And needs minimum expectations and assumptions which are well aligned to the issues facing companies/stakeholders/...and Ofwat.

Ofwat calibration of incentives

Determinations balanced in the round.

So what are the risks and consequences?

Both companies and Ofwat may lack the regulatory tools to address the issues companies face. This means the real risks may not be exposed at all with the following potential consequences….

CUSTOMERS

Companies are focused towards regulators not customers

Customers' views are not truly reflected in decision making and they pay for things that they do not value

STAKEHOLDERS

Reduced confidence in companies as legitimate delivers of local public value

ENVIRONMENT

Less innovation and less environmental value created for the available envelope

OFWAT

Companies tell Ofwat what it wants to hear not what it should know

Determinations do not represent a fair-bet for a well-run company

INVESTORS

Investors uncertain of the true risk profiles faced by individual companies and the legitimacy risks of failing to deliver for stakeholders.

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Solutions: the way forward for PR24

There is scope for Ofwat to adapt its methods and processes for PR24

Method

Ensure that company-specific information feeds into price control decision making, e.g. on P10/P90 risk analysis

Allow companies to propose approaches that will address the specific challenges that they face and do not close off their application in a detemination. For example:

- Targeted cost sharing rates by investment driver
- Overall balancing of the ODI package
- Notified items
- Gated processes
- Potential for using PCDs as uncertainty mechanisms

Recalibrate business plan incentives to promote credible plans that do the right thing for stakeholders. This should include:

- Removal of the apparent potential for a plan diversity penalty through the quality assessment approach;
- Reframing of the ambition assessment around the concept of risk plans considered too cautious for their circumstances will be adjusted by Ofwat through tougher outcome targets/efficiency challenges in the usual way.
- Companies to state whether and how they have balanced risk or accepted more risk (for reward).

Process

Earlier engagement prior to business plan submission e.g. Board/Ofwat meetings to explain plans and how they balance risk within the context of the real company in advance of submission

Engagement before and after Draft Determinations including and beyond meetings on LTDS in early 2023.

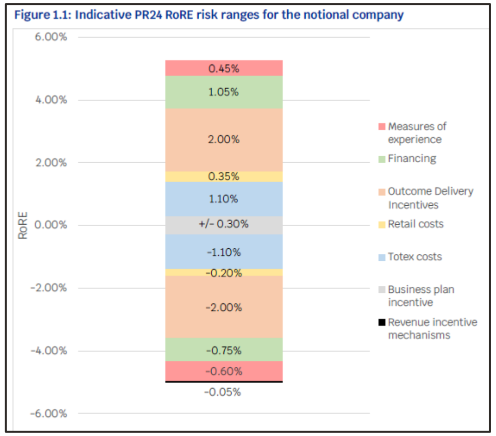
We don't think these solutions will add further complexity, given that **many of these remain theoretically available** within the current regulatory toolkit.
However, **Ofwat should provide greater signalling and clarity to companies on the circumstances in which these approaches could be legitimately applied** at PR24 without being deemed to have proposed low quality plans.

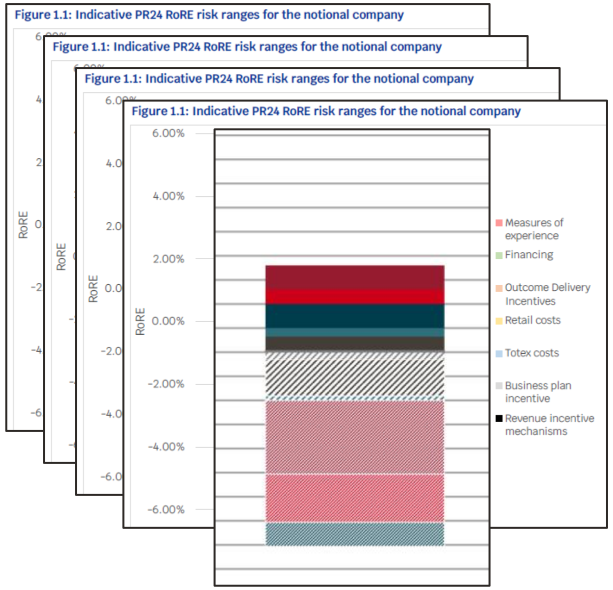
A revised model for business plan assessments

Companies and Ofwat could categorise ambition and credibility of plans in relation to the way they seek to meet the challenges/risks faced

Ofwat view of a notional efficient company

Multiple realities of PR24 reflecting individual company strategic context, current and future pressures, legacy issues





Company interventions and plan categorisation?

Companies able to propose approaches/mechanisms that balance risk and reward, or which accept more risk for more reward

Board considers plan is ambitious and credible….

…or that plan is well-constructed and balanced given its strategic context

Ofwat plan categorisation

Lacking credibility/of poor quality	Ambitious and credible
Overly-cautious and requiring intervention given strategic context	Well-constructed and balanced given strategic context

Relevant precedent: IPART in Australia

Table 1 Annual revenue adjustments based on the quality of pricing proposal

Price review	Business self-assessment		
IPART assessment	Leading	Advanced	Standard
Leading	2.5%	1.75%	n/a
Advanced	1%	1.25%	0.5%
Standard	-1%	-0.5%	0%
Sub-standard	Business to review proposal and resubmit		

Note: The table shows the financial reward businesses can earn for high-quality proposals. For instance, if a business submits a proposal it considers as Leading, and IPART agrees it is Leading, the business will earn a reward equivalent to 2.5% of its annual revenue. On the other hand, if a business submits a proposal it considers Advanced, but IPART grades it as Standard, the business is penalised by 0.5% of its annual revenue.

The incentive is focused on both information revelation as well as becoming "leading"

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