

July 2022

Creating tomorrow, together:
consulting on our methodology for PR24

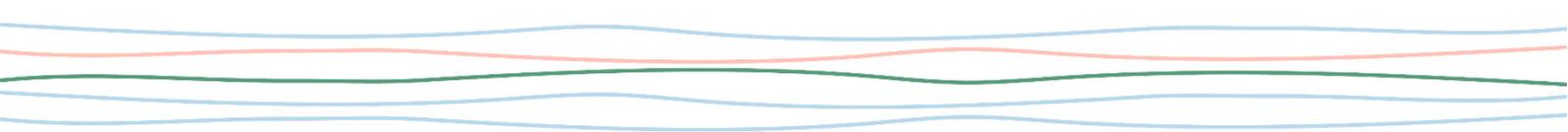
**Delivering Welsh Government
priorities for the Welsh water
sector through our
2024 price review
draft methodology**

Ofwat

Introduction

The Welsh Government has set out strategic priorities and objectives for Ofwat in its strategic priorities and objectives statement, the draft new Strategic Policy Statement (SPS), laid before the Senedd on 6 July.¹ We will be required to act in accordance with the final SPS when we set price controls for Welsh water companies in 2024 and in carrying out our other relevant functions relating wholly or mainly to Wales.²

The Welsh Government has framed the draft new SPS within the context of the Well-being of Future Generations (Wales) Act 2015 and its Programme for Government 2021-2026. It sets out a series of strategic priorities and objectives for Ofwat. Welsh Government expects Ofwat to develop a regulatory framework that is applicable to Wales based on sound evidence relevant in a Welsh context.



In summary the Welsh Government's strategic objectives for how it expects Ofwat to carry out its functions are to:

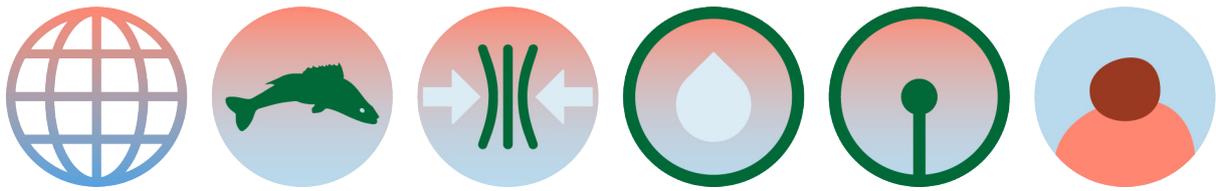
- adopt an **outcomes** focused approach that promotes an appropriate focus on addressing **long-term** risks, safeguarding long-term resilience and performance and ensuring that the timing of investment results in intergenerational equity;
- pursue a **preventative** approach by encouraging companies to understand and consider how problems could be addressed at source;
- deliver **value for money** for customers, communities and the environment and challenge companies to provide sustainable and effective support to vulnerable customers and customers who are struggling to pay;
- challenge companies 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;

¹ Under section 2B of the Water Industry Act 1991.

² For these purposes, "relevant functions relating wholly or mainly to Wales" means the functions mentioned in section 2(1) of the Water Industry Act 1991 so far as they relate to appointment areas wholly or mainly in Wales. An "appointment area" is the area for which a company holds an appointment as a water and/or sewerage undertaker.

- encourage companies to meaningfully **involve**, engage with and take account of the views of customers and stakeholders on long term outcomes, priorities and pace of delivery; and use effective **collaboration** to maximise the impact and effectiveness of regulation;
- deliver a cohesive and transparent **regulatory framework** that, taken as a whole, is proportionate, effective, transparent and efficient and challenges companies to provide clear and compelling evidence to underpin their investment plans and challenge companies to seek **new ways of working** to deliver for customers and the environment more efficiently.

The Welsh Government sets out more detailed expectations of Ofwat in relation to five strategic priorities:



- **climate and nature emergencies;**
- **environment;**
- **resilience;**
- **asset health; and**
- **customers and communities.**

We have reflected the draft new SPS in our draft methodology.

We understand the urgency required to respond to the climate and nature emergencies, and the scale of environmental improvements that are needed. We understand that customers need to be meaningfully heard and need reliable and resilient services. We're 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 also understand that the way we work, not just the work we do, is important and that this applies to us, to companies, and to the sector as a whole.

In response 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.**
- **Delivering greater environmental and social value.**
- **Reflecting a clearer understanding of customers and communities.**
- **Driving improvements through efficiency and innovation.**



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 full new SPS. We will continue to work closely with Welsh Government in this respect.

The rest of this document sets out a summary of how our proposed policies support the delivery of the Welsh Government's five strategic priorities. For each priority we set out how we have taken account of the Welsh Government's strategic objectives.

Climate and nature emergencies

We want companies to deliver a scale of ambition at a pace that responds to the demands of the climate and nature emergencies – now and for the long term. To help achieve this and to 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. We will require companies to set their business plans for 2025–2030 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 and Welsh Government. The approach to long-term delivery strategies aligns with the Welsh Government's requirement to consider **circular economy and foundation economy principles**.



Companies must identify the **long-term outcomes** they need to deliver in light of the ambitions of Welsh Government, customers and communities. We have introduced the **collaborative approach in Wales** that will enable Welsh stakeholders to provide steers on the high-level outcomes and priorities for the water sector in Wales that companies should reflect in their long-term delivery strategies and business plans.

We propose to require companies to adopt a **package of common performance commitments for 2025–30** which will cover key climate change and environment related issues including biodiversity, operational greenhouse gas emissions, water demand, river water quality, bathing water and a range of measures to reduce the impact on water bodies. We consider that the proposed performance commitment framework aligns with the **Welsh Government requirement for an integrated, outcomes and standards-based approach** to improving the quality of water bodies that also reflects the sustainable management of natural resources approach.

By setting an outcomes framework that covers a wide range of environmental issues we are encouraging companies to consider their wider impacts when making investment and operational decisions. For example, taking into account the biodiversity and operational greenhouse gas impacts of investments to improve river water quality in a holistic and integrated way.

We expect companies to continue to reduce greenhouse gas emissions and move towards net zero through their on-going activities funded through the base expenditure allowance. We propose to allow **specific enhancement expenditure to reduce greenhouse gas emissions** further and are introducing **net zero challenge**

funding to allow efficient companies to go further than their peers. This responds to the need to inject pace into the response to climate change.

Our outcomes framework will **hold companies to account for the outcomes that customers pay for** – and incentivises companies to go beyond this where this is in the interests of customers and the environment.

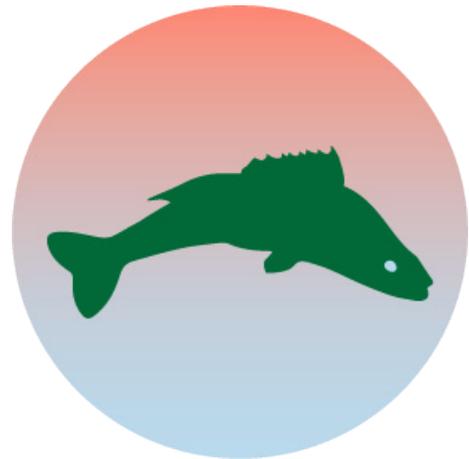
We are committed to **maintaining the overall outcomes framework in future price reviews**. We expect the outcomes we are incentivising at PR24 to be of enduring interest to customers and the environment, and we expect them to be financially incentivised in future price review periods. If a company stretches itself and performs better than others, in future price control periods it will gain outperformance payments, and conversely if it falls behind it will pay underperformance payments'. We are also open to proposals to provide greater clarity over our intended approach to ODIs in PR29 where it can be demonstrated that this would clearly be in the interests of customers.

With our focus on the long term, we are keen to facilitate **multi-period investments whilst also protecting customers**. We consider that the move towards long-term delivery strategies and adaptive planning will provide even greater flexibility to companies in how they deliver outcomes for customers, communities, and the environment. This methodology seeks to facilitate efficient long-term investment, so the right interventions are delivered, and investments are sequenced appropriately, for example, through facilitating multi-period investments, funding appropriate preparatory work and the retention of transition funding.

We support a move towards a **more outcomes focussed NEP** and are working with Natural Resources Wales to achieve this, recognising that this approach also aligns with the requirement in Wales for the sustainable management of natural resources approach. This is consistent with the approach that we try to take for other enhancement expenditure. Under this approach we set the performance levels we expect companies to deliver and then set the efficient totex allowances needed to support the delivery of these outcomes. This will help companies choose the best approach to deliver the outcomes required in the NEP, facilitating the use of nature-based solutions.

We propose that companies have **customer support for enhancement expenditure to deliver wider environmental benefit that goes further than their formal targets and statutory requirements**. Companies should conduct company-specific engagement with their customers to inform such proposals. We are proposing **open challenge sessions** which will give stakeholders, including consumer groups and local

environmental bodies, the opportunity to question and challenge companies during business plan development and following submission of final plans and we will work with the Wales PR24 Forum to seek opportunities for alignment, mindful of the need for customer voices to be heard in the forum.



Environment

We want companies to set a scale and pace of ambition that will drive continuous environmental improvement and that will drive the sustainable and efficient management of natural resources.

Our approach to long-term delivery strategies is founded on adaptive planning and management of risks. Adaptive plans will take account of the impact of plausible alternative scenarios, including on climate change and population growth. The approach therefore lends itself to taking a **long-term preventative approach**.

Companies already have **several long-term strategic planning frameworks**. These frameworks include water resources management plans (WRMPs) and drainage and wastewater management plans (DWMPs). These frameworks are complemented by the NEP in Wales. These frameworks set a long-term direction of travel for the key areas of company activities and involve collaboration with other regulators and stakeholders.

In keeping with the principles of sustainable management of natural resources we also expect companies to adopt **integrated approaches**. River basin management plans establish an integrated approach for the protection and sustainable use of the water environment. We expect companies to take account of river basin management plans when developing their NEP programmes and enhancement proposals.

Through DWMPs we expect companies to consider a wide range of options that mitigate the risks identified, including **nature-based solutions, catchment-scale schemes and traditional grey infrastructure interventions**. Many wastewater system performance risks relate to network operational or maintenance approaches that can be improved. Therefore, before exploring enhancement options we will expect companies to demonstrate that adjustments to operational and maintenance regimes have been implemented. Options should demonstrate that wider environmental improvements and collaborative partnership working have been incorporated.

Through both WRMPs and DWMPs, companies should **embrace innovative options including those making use of smart data and networks**. Companies' plans should make efficient use of current technology, investigate the use of emerging technology and future **innovation**, as well as explore nature-based solutions. We also expect a full consideration of **operational interventions, where these are appropriate, for example during low probability events**. This will help to avoid developing unnecessary infrastructure which may have low utilisation or not be required if risks do not transpire.

We will require the **outputs from strategic planning frameworks to inform, and align with, each company's long-term delivery strategy**. We expect companies to have a strong focus on all the strategic planning frameworks to ensure they are robust, deliverable, and flexible in meeting customer expectations and environmental outcomes. **We expect consistency between final WRMPs and DWMPs and the company long-term delivery strategies and business plans at PR24**. We will also assess how companies have reflected our expectations in their final WRMPs and DWMPs, and how they have responded to our feedback provided throughout the planning process. We will take this into account, together with any differences between final plans and business plans, when we assess expenditure proposals and business plans

Reflective of the **sustainable management of natural resources** approach in Wales we want to facilitate the greater use of nature-based solutions. Nature-based solutions can generate additional social and environmental benefits but can have additional operating expenditure. In response to companies suggesting that there are barriers to taking forward opex-based solutions, we propose to give more funding certainty to opex based solutions, such as allowing them to capitalise operating expenditure or by providing a **ten-year allowance** for the efficient operating expenditure related to nature-based solutions. This should encourage greater use of nature-based solutions at PR24.

We will require companies to explore options that seek to **address multiple drivers**, such as managing surface water that benefits both flooding and water quality performance. Companies will need to demonstrate how **interdependencies** with other stakeholders' strategic plans have been considered. Some options may need longer lead times to evolve and will need to be developed in collaboration with other stakeholders meaning they may not always be appropriate for near term needs. The options should fully consider **partnership working opportunities, including co-funding and co-delivery**.

We want companies to deliver **best value for customers, communities, and the environment**. We want to them to provide greater public value and to deliver wider

environmental and social benefits in the course of carrying out their statutory functions. To support this, we are proposing to take into account wider environmental and social benefits more robustly and extensively in our assessment of enhancement expenditure proposals to encourage companies to deliver best value.

Another important principle of our approach is to **ensure that companies are incentivised to continue to improve performance over the long-term.**

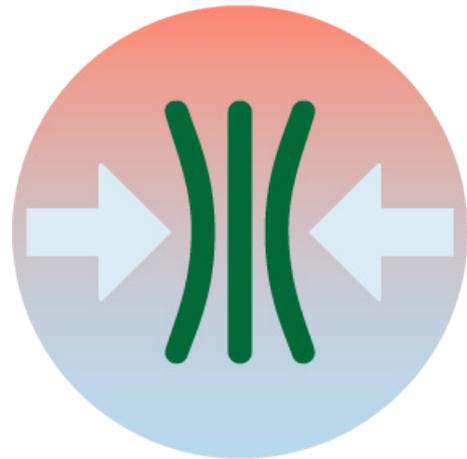
We will require companies to report **progress in reducing overall water demand** and the components of this demand (leakage, per capita consumption (PCC) and business demand) in their annual regulatory reporting. We are consulting on whether we should incentivise delivery at an individual component level or at the overall water demand level. We expect to appropriately incentivise performance improvements, and to set stretching but achievable target service levels. Consistent with the recommendations of an independent report that was commissioned by water companies and retailers as part of the Industry Action Plan to **improve the water efficiency of businesses**, we propose to incentivise reductions in business consumption through PR24 via the introduction of a new performance commitment.

We recognise that in the face of the challenges the water sector faces – climate change, the need to improve river water quality, and the pressures on people's finances – companies need to **innovate constantly** to achieve best outcome for customers and the environment at a cost people can afford. We therefore propose to more strongly incentivise innovation and very high performance through enhanced incentives on key performance commitments, such as sewer flooding and pollution incidents:

We also expect to continue the **Innovation Fund in PR24**. Following the positive feedback to the April 2022 consultation on the future of the Innovation Fund, 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.

Resilience

We recognise the importance Welsh Government and Natural Resources Wales place on economic, environmental, and social resilience associated with **water resources in Wales**, in particular when considering water transfers within and outside of Wales. We require water companies to adhere with the joint regulator **water resources planning guideline and Welsh Government WRMP guiding principles**, and to work in close collaboration with all key stakeholders including the Regulators' Alliance for Progressing Infrastructure Development (RAPID). We also want to continue working closely with Welsh Government, NRW and others on water resources resilience as we work towards the final methodology and ahead to PR29.



We want companies to ensure current and future resilience of water and wastewater services is understood and managed through robust, adaptive, and evidence-based plans and the management of risks. We **fund water companies to be resilient over the long term through a combination of base and enhancement expenditure**. Both water resource 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.

As well as our performance commitments supporting asset health, we are developing an **integrated monitoring framework to provide a more complete view of asset health and operational resilience**. We are striving for strong operational resilience with robust infrastructure and services and the right **skills and systems**; strong corporate resilience with good board leadership, governance, accountability and assurance; and strong financial resilience with robust financial arrangements including capital structures. Some of this policy development is taking place outside PR24.

We expect companies to consider risks and uncertainties when evaluating the use of nature-based solutions. Companies should use nature-based solutions when they have a **reasonably high degree of confidence** that the solution will deliver the desired outcomes and allow them to meet their statutory requirements. Where this is not the case, companies can propose running a **proportional and timely pilot scheme**. In this case, companies should set out how they propose to monitor and report the progress and outcomes of the pilot scheme, including how the data will be shared with other companies. This will help reduce the risks and uncertainties for these solutions in

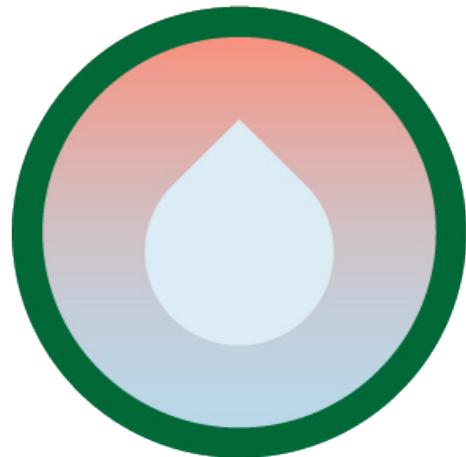
future reviews and so support innovation while manage the risks for customers and the environment.

We propose to **amend the definition of resilience enhancement to cover the management of increasing risks from hazards that are beyond their control**, which are not covered by other enhancement areas. An example is hazard is fluvial flooding of company assets

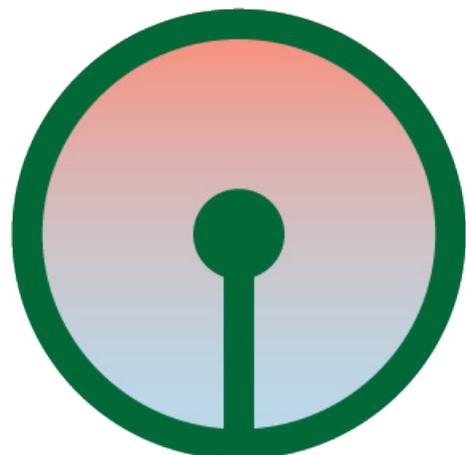
Expenditure on the delivery of the **Security and Emergency Measures Direction** (SEMD) outcomes will contribute to resilience to security threats and operational incidents. We are working closely with the Drinking Water Inspectorate to ensure efficient delivery of companies' legal obligations to protect against the wide range of new security threats and preparedness requirements. We propose to provide additional enhancement allowances to cover new designations and step changes to a new improved level of service.

Asset health

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 want companies to monitor their asset health and provide forward looking plans to address issues over the long-term. We are ensuring that companies are incentivised to deliver their long-term plans efficiently while also ensuring the appropriate long-term stewardship of their assets. For **asset health performance commitments**, we want to consider further performance data to determine if it is appropriate to set the performance level on a common or company specific basis. Our proposed PR24 outcomes regime includes key **asset health performance commitments** – mains repairs, unplanned outages and sewer collapses. These performance commitments incentivise companies to maintain their networks and encourage service and asset health improvements.



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 expect companies to have regard to the balance of recovery of costs between different generations of customers and framework is constructed to ensure that we **protect the interests of customers now and in the long term**.

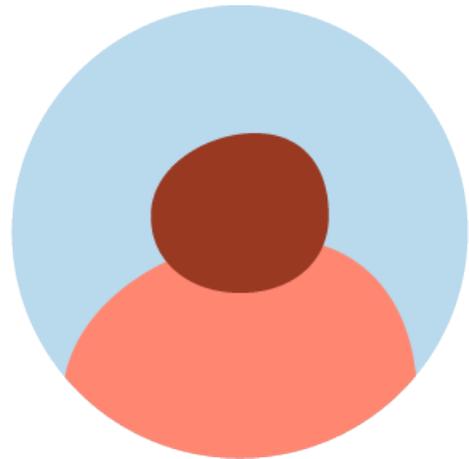
For PR24 we are proposing to include **more of a forward look in our base expenditure modelling**. We already include forecast cost drivers in our base cost models so that allowances reflect future changes in scale, density and complexity of water and wastewater treatment. We are collecting additional data where treatment complexity might increase in the future so we can take this into account when setting efficient expenditure allowances. We are open to considering company evidence on additional exogenous factors / cost drivers that require a step change in efficient maintenance expenditure through the cost adjustment claim process.

We expect company long-term delivery strategies to inform their PR24 business plans. Long-term delivery strategies will provide an adaptive plan of company planned enhancement expenditure over 2025-30 and the long term. Adaptive plans will take account of the impact of plausible alternative scenarios, including on climate change and population growth.

Outside of PR24 we are also developing an integrated monitoring framework to provide a more complete view of asset health and operational resilience. We have set out proposals to explore and test wider measures associated with the health and performance of water and wastewater assets in our [operational resilience discussion paper](#).

Customers and communities

Affordability is a golden thread throughout our framework. For PR24 we expect companies' business plan submissions to recognise and address the needs and priorities of the generality of current and future customers with a focus on concerns about the affordability of bills. Companies will therefore need to develop business plans that deliver:



- overall affordability, including providing value for money;
- affordability for current and future customers; and
- affordability for residential customers struggling, or at risk of struggling to pay.

One of the most important ways we drive overall affordability is through incentivising and challenging efficiency and productivity improvements. We will do this through setting a stretching but achievable cost efficiency challenge to encourage lagging companies to catch-up with the leading companies in the sector and leading companies to push themselves to improve their efficiency still further.

We will expect companies to support affordability in PR24 through delivering:

- a step-change in efficiency;
- innovating and working in partnerships to deliver more for customers;
- taking a long-term focus to reduce lifetime costs and phase investments over time; clearly understanding customers' views, including their expectations about increasing bills today compared to the future;
- and clearly understanding and supporting customers' diverse needs on a day-to-day basis, not just simply for a price review;
- demonstrating their plans are affordable, including for those struggling to pay;
- taking steps, for example bill smoothing, to manage the impact on affordability and fairness between current and future customers.

Welsh Government is developing proposals on the Single Social Tariff. We are asking companies to submit **plans that address two scenarios:**

1. implementation of the Single Social Tariff; and
2. continuation and development of companies' existing offers of support to customers that struggle to pay their bills.

We also support **affordability outside of the price review**, for example through consulting on charging rules, licence changes to support high quality customer service, and our Paying Fair Guidelines which set minimum expectations for supporting customers in debt.

We have already been using our other regulatory tools to encourage water companies to **implement CCW's Affordability Review recommendations/actions**, consistent with the Welsh Government's expectation that we should collaborate with others to implement relevant recommendations in a way that benefits customers of Welsh water companies. For instance, our recently published Paying Fair guidelines covered several of the CCW actions directed at water companies. CCW are also a core member of the Wales PR24 Forum and we expect that discussions reflecting the specific affordability context in Wales will help inform companies' long term delivery strategies and business plans.

We plan to continue to focus our efforts on ensuring affordability support is available, appropriately targeted and easily accessible and we remain committed to data sharing initiatives and are continuing to drive the sector to engage constructively with the development of Priority Services Register data sharing between the water and energy sectors.

Core to our strategy is that companies' business plans need to **reflect the needs, expectations and priorities of customers and communities** for the services and benefits the company will deliver. Our ambition is that residential and business **customers' voices are heard more directly and more meaningfully** in PR24 than ever before and that in turn these voices meaningfully inform long term delivery strategies and business plans. We hope that higher quality, more transparent engagement will help further foster the relationships needed to make greater progress on the big challenges like responding to the nature and climate emergencies, expediting environmental improvements and responding to the pressures on people's finances. This is particularly the case where delivery of outcomes will benefit from companies working in **partnership with their customers and communities** to deliver ambition at pace.

Based upon the expectations for customer engagement we have already set out we are working closely with CCW and companies to develop a common approach to researching **customers' views of the affordability and acceptability of** plans. This will ensure that customers' views are comparable across companies.

We are also doing **collaborative customer research**, across all companies, to gain an understanding of what is important to customers and separately seeking customers' views at company and country level to directly influence outcome delivery incentives for each company.

Listening to feedback after PR19 and reflective of Welsh circumstances and policy context, we are introducing a new **collaborative approach to PR24 in Wales**. This approach will ensure that Welsh stakeholders, through the **Wales PR24 Forum**, will collaborate to provide steers on the strategic outcomes and priorities for the water sector in Wales, these steers will in turn help inform companies' long-term delivery strategies and business plans. The customer's voice is a key area that the **Wales PR24 Forum** will consider, and we will seek to ensure that the findings from our customer research will inform these discussions.

We will also ensure that customers and other stakeholders can comment directly on companies' plans. We are proposing that each company should hold **open challenge sessions** at which customers, community and environmental representatives will be able to ask open questions to the company about their draft and final plans. Companies will need to demonstrate that their plans are affordable, including for those struggling to pay. We aim to align these sessions for the Welsh companies with the activities of the Wales PR24 Forum as far as possible.

We also want to see **companies collaborate**. Our public value principles already provide some guidance about how companies should collaborate with others to optimise solutions and maximise benefits, seeking to align stakeholder interests where possible, and leveraging a fair share of third-party contributions where needed. For example, we want collaboration to help identify and manifest strategic regional water resources solutions or pursue sector changing innovations through the innovation fund.

When developing business plans, we expect **companies to fully consider partnership working opportunities, including co-funding and co-delivery**. Where there are material benefits to third parties, we expect companies to actively seek contributions from these parties. The size of these contributions should be in proportion to the benefits that these parties can expect to receive through the scheme. To further encourage companies to maximise **co-funding opportunities**, we propose to take account of third-party contributions in our benchmarking of enhancement expenditure when seeking to deliver wider economic benefits.

In recognising the Welsh Government's position on competition we are proposing to **facilitate any increase in the eligibility threshold for competition in the business retail market**. Price controls would protect the interests of any business customer who cannot switch their supplier.

We also want to **improve the way we assess the costs of bioresources activities to encourage the role of market-based solutions**. We propose to strengthen our approach

to comparative competition by including more costs with our benchmarking models. Companies would still decide how their sludge is transported, treated and disposed.

On **developer services**, we propose to retain price control regulation where competition is weak between water companies, self-lay providers and new appointees, for example in network reinforcement. Where competition is stronger, for example in larger developments, we propose to remove price control regulation. These proposals assume that we will establish new connection charging rules for Welsh companies on or prior to April 2025. We will keep under review our approach to developer services to ensure it is fit for purpose to support economic development in Wales.

**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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