PR24 draft methodology stakeholder Q&A: Batch 1

2 August 2022

Who will run the challenge sessions to ensure that water companies are properly scrutinised and the sessions do not simply become an exercise where water companies present their information in a one-way 'PR' process? How often will these public sessions occur, and will there be opportunities during the 5 year cycle for the public to hear about the rate of progress being made and performance against the agreed measures, rather than only holding meetings at the start of PR24 where water companies would be able to set up their plans?

'Creating tomorrow, together: consulting on our methodology for PR24', section 4.4, p50, explains:

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

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

Is Ofwat proposing to act inside the 5 year PR24 cycle to assess on-going water company performance, and will the findings from those interim assessments be available to the public?

In circumstances where water company performance may not have kept pace with the original commitments made through PR24, will there be additional public meetings to explore why this has happened?

Is Ofwat proposing that it would be possible to further intervene and use regulatory powers to make any necessary adjustments to agreements and performance targets inside the PR24 5-year period, in any cases of slow/weak water company performance? Alternatively, is it the case that each water company will be only be assessed at the end of PR24 and new expectations would be set at that point in time?

Outside of the price review we will continue to use a range of tools to hold companies to account for their delivery for customers, communities and the environment.

This includes ongoing engagement with companies and our annual monitoring and assessment of performance. We publish our findings and the datasets underlying our analysis on our website, for example:

- Our annual service delivery report monitors companies' performance on key components of outcome delivery and expenditure.

- Our annual determinations of outcome delivery incentives demonstrate how companies must adjust customers' bills when service delivery exceeds or falls short of agreed outcome targets.

- Our annual monitoring financial resilience report provides insight into companies' financial resilience.

Currently, we do not have plans for public challenge sessions during 2025-30 that would explore the reasons for shortfalls in company performance. However, we have set standards (section 2, p8) which explain that customer challenge is ongoing, addressing both development and delivery of business plans. Companies should be able to provide evidence of welcoming and responding to challenges on their day-to-day performance as well as during the development of their business plans for price reviews and long term delivery strategies. At Ofwat, we consider and address the causes of poor performance during ongoing engagement, monitoring and analysis and will continue to report our findings to stakeholders annually in the publications listed above.

Finally, when our performance monitoring suggests companies may not be complying with the statutory or licence obligations we are responsible for enforcing, we may take enforcement action, including seeking legally binding undertakings and issuing fines. For example, undertakings may require a company to recover the shortfall in its performance to the level in its final determination.

In early meetings it was stated that the ODI rates research would be available in January 23. I note in the draft methodology this has changed to Winter 2022-23. Are you able to confirm that this still means January in practice, or whether there is a chance the rates will not be available until February?

We will share initial ODI rates as soon as possible and understand the need for clarity and certainty. We are aiming for this to be in January 2023.

Question A6.2 states "Do you agree that C-MeX needs to adapt to provide better service to vulnerable and worse served customers?" We could not find any reference to "worse served customers" elsewhere in the consultation. Could Ofwat clarify what they mean by "worse served customers"?

We mean customers that experience very bad service, and are so more likely to complain to CCW. This is explained on page 21 of section 3.1 of Appendix 6.

In Appendix 9, Section 4.1, Ofwat states: "We consider a reasonable starting assumption is to expect a common level of performance from base expenditure, given our base cost models include explanatory variables that cover a range of exogenous factors that impact companies. Some companies therefore receive a higher expenditure allowance than others, in part because of the additional challenges they face in delivering services to their customers. Adjusting for these factors in our performance expectations as well as our efficient cost allowance would double count their impacts.

"But we acknowledge that our base cost models may not reflect all drivers of differential performance. We will therefore consider setting company-specific PCLs where performance is materially affected by an exogenous factor not captured in our base cost models and/or there are differences in historical enhancement expenditure allowances."

But what about where levels of performance are not standard (i.e. leakage) which is both base and enhancement. The CMA offered various observations on the complexities of leakage base and enhancement costs in their final

findings (for example over the need to reduce leakage over a suite of measures, rather than to maintain steady state leakage).

Does Ofwat have a view on whether this type of performance should become a company specific cost adjustment claim or an industry standard mechanism or something else? Could you point us to where this is clarified in the methodology, specifically for leakage and other non-standard PCLs.

In the PR24 draft methodology we identified performance commitments where we expect to set company-specific PCLs following consideration of base and enhancement expenditure allowances. Leakage is an example of one such performance commitment measures (Ofwat, 'Creating tomorrow, together: consulting on our methodology for PR24 Appendix 9: Setting expenditure allowances', p.69, Table 4.1).

For all PCLs we propose to use historical performance data, company forecasts (PR19 and PR24) and PR19 PCLs (where available) to forecast the level of performance we expect companies to deliver through their base expenditure allowance. (Ofwat, 'Creating tomorrow, together: consulting on our methodology for PR24 Appendix 9: Setting expenditure allowances', Section 4.3, pp.76-78). Leakage and PCC are examples of performance commitments where we expect base expenditure to fund a company specific level of performance. We have also discussed the specific example of using econometric modelling to determine the levels of PCC we could expect a company to deliver (Ofwat, 'Creating tomorrow, together: consulting on our methodology for PR24 Appendix 9: Setting expenditure allowances', p. 73, 'Box 1: Determining efficient per capita consumption for each company').

We are still considering the approach for determining the level of leakage reduction we expect an efficient company to deliver with its base allowance. This will also inform our assessment of where a company may require enhancement expenditure to go beyond this level. Most companies did not receive enhancement expenditure to improve leakage in PR19. We would expect companies to draw on their experience of delivering recent leakage performance improvements to develop forecasts of further leakage reductions they can achieve from base expenditure for 2025-30 period and beyond. We discuss our expectations for companies with respect to leakage in Ofwat, 'Creating tomorrow, together: consulting on our methodology for PR24 Appendix 9: Setting expenditure allowances', pp. 102-103, Section 5.2.3.
"We expect companies to maximise the leakage reduction they can deliver from their base expenditure allowances when developing leakage reduction proposals for their WRMPs and business plans. Companies should provide sufficient and convincing evidence to justify any enhancement requests for leakage reduction. This should include consideration of:

- the company's performance levels relative to others;
- how the reduction represents best value over the long term;
- how best practice and innovation has been incorporated into their plans;
- how the company is building upon its learnings from the current period (2020-25); and
- evidence that costs are efficient."

We also have requested an additional data submission regarding leakage costs and activities which we will consider to inform our approach at PR24 and business plan table data requirements for the PR24 final methodology (Ofwat, 'IN 22/02 Cost assessment data requests', April 2022).

Appendix 9, Section 4.4.1 - We note Ofwat's comments on adjusting PCLs to take account of enhancement expenditure allowances and the two elements listed on page 81.

"There are two important elements of this information:

1. performance improvements delivered as part of a company's best value long-term delivery strategy. This includes the impact of all base and enhancement expenditure over the long-term period; and

2. performance improvements delivered over the 2025-35 period, from the schemes companies commence in the 2025-30 period. These improvements should clearly identify the influence of best value enhancement expenditure made in 2020-25 on the 2025-35 performance levels.

"For the avoidance of doubt the difference between elements 1) and 2) is:

• in element 1), the impact of all enhancement expenditure for 2025-30 and beyond is represented in the performance trend; and

• in element 2), only the influence of enhancement expenditure for schemes commencing in 2025-30 is shown in the 2025-35 period."

For element 2, leakage is an example – but the references are a conclusion – the second bit contradicts the first bit in the periods referenced? Could we just clarify whether the date periods are correct as shown?

There is an error in the date under point 2 that we will amend in the published Appendix. 'These improvements should clearly identify the influence of best value enhancement expenditure made in 2020-25 on the 2025-35 performance levels.' should read 'These improvements should clearly identify the influence of best value enhancement expenditure made in 2025-30 on the 2025-35 performance levels.'

Section 4.4.2 states "We will achieve a clearer link between cost allowances and PCLs at PR24 by using historical outturn data as the basis of setting efficient base expenditure allowances and PCLs. Historical outturn performance data provides a strong basis for demonstrating what performance levels can be achieved through base expenditure. Companies are expected to forecast performance improvements from base expenditure into their PR24 business plans and long-term delivery strategies. We will compare our performance forecasts based on historical trends against company forecasts to understand the level of stretch proposed by each company. We will consider if companies' supporting evidence to explain their forecasts is compelling and justifies an adjustment to our independent forecasts." However we understood long-term delivery strategies only applied to enhancement proposals and not base expenditure extrapolation and the reference to base extrapolation into long term delivery strategies confused us here. Could you clarify that if long-term delivery strategies are about enhancement spend (Ofwat guidance as we understood it) – what is the reference doing in here to base?

As set out in Section 3.5.2 of our final guidance on long-term delivery strategies, we expect companies to clearly set out the expected performance improvements from base expenditure towards each of the outcomes and metrics set out in their ambition. The adaptive pathways should then set out what enhancement expenditure is required, over and above what base buys, to achieve the company's long-term ambition in a wide range of plausible scenarios.

Appendix 9, Section 6.1.2 - On "Assessing and valuing long-term benefits" Ofwat states "We agree with stakeholders that we need a common approach to valuing benefits. Where possible, companies should use the valuations identified by the collaborative research on initial outcome delivery incentives."

Our understanding was that the collaborative research on initial outcome delivery incentives was not meant to be ascribing CBA values. It was instead just meant to set ODI incentive rates. For example in "PR24 and beyond position paper: Collaborative customer research for PR24" the scope listed is limited (it states "the ODI rates research will inform the ODI rates for common PCs"). Could Ofwat please clarify whether our understanding of the limited scope of the ODI rates research is correct or if not, to please elaborate on why the ODI rates research is now being intended to ascribe CBA values? What has

changed since the role of the collaborative research for ODI rates and not company cost benefit was set out - could you clarify if there is somewhere in the collaborative research or the methodology that considers this change in approach.

While it is correct that the primary purpose of the collaborative customer research is to derive outcome delivery incentive rates, for the reasons set out in appendix 9, the benefit values can also be used to inform benefit valuations within any cost-benefit analysis. This has the advantage of aligning with the outcomes measured by performance commitments. As we note in appendix 8, we intend to share customer valuations from the fieldwork in October 2022, with valuations mapped to final performance commitment definitions in winter 2022-23.

For water quality contacts in appendix 6 Ofwat states "we propose the type and reporting of water quality contacts are aligned with the Discover Water website which sources specific data from the DWI, collected in accordance with the guidance included in its information letter 1/2006 on Annual Provision of Information on Consumer Contacts".

In appendix 7 the unit refers to the "Number of consumer contacts per 10,000 population".

There are differences in how this PC is reported between thees two sources. On Discover Water the metric is measured per 10,000 people. However the DWI letter 1/2006 on Annual Provision of Information on Consumer Contact (which we aligned our PR19 metrics to and which is referenced in the PR19 outcomes definitions - https://www.ofwat.gov.uk/outcomes-definitions-pr19/) is reported as contacts per 1000 population.

Could Ofwat please clarify the unit desired - it is either per 10,000 or per 1,000 population but it cannot be both?

The definition for 'Water quality contacts' has been taken from that used at PR19. The Discover Water multiplies the DWI figure by 10. We will confirm the unit to be used in the Final Methodology document.

For Discharge permit compliance could Ofwat please confirm whether this is just intended to apply to a wastewater company (via the wastewater network plus price control) or whether it should also apply to a water service (when not in the EPA as currently)? In 3.92 of appendix 7 it does state that "a discharge

can be confirmed as failing for a number of breaches of a numeric permit at wastewater treatment works and water treatment works".

We have proposed that the discharge permit compliance PC only applies to water and wastewater companies. For these companies, it applies to both water and wastewater treatment works.

For biodiversity, in 3.1.1. Ofwat state "This is reported per hectare of company owned land. Increases in biodiversity units can be recorded on both company-owned land and other land where habitat is improved in the process of a water company carrying out its functions."

However in 3.1.4 under "measurement unit and decimal places" it states "Biodiversity units per hectare of appointed business company land."

For consistency, could we clarify the measurement unit and decimal places should be revised to read: "Biodiversity units per hectare of appointed business company land and other land where habitat is improved in the process of a water company carrying out its functions"?

We considered it appropriate to normalise the PC to allow more meaningful comparisons between companies (although noting not all companies will necessarily have the same opportunities). We propose that the normalisation is the area of company owned land.

This is different to the land where we propose increases in biodiversity can be recorded, as this includes other land where habitat is improved in the process of a water company carrying out its functions.

Chapter 8, Section 5.2.3 – In the footnote on this page Ofwat state "For the compliance risk index, frontier performance has been 99.99% in 2017 and 2018, 99.97% in 2019 and 99.98% in 2020."

Could Ofwat please clarify these percentages as CRI is an index?

This is equivalent to index values of 0.01, 0.03 and 0.02.

We are seeking clarification on expectations set out in the PR24 draft methodology on Storm Overflow performance by the end of AMP7.

Ofwat writes in Appendix 9, page 102 section 5.2.2 that there is an expectation that all companies reduce their use of storm overflows to meet a target of an average number of 20 spills per overflow by 2025 based on commitments made by Anglian Water, South West Water, Severn Trent Water and Northumbrian Water.

We also note that in Appendix 7 page 128 section 3.12 Storm Overflows, that whilst the definition of the new proposed common Performance Commitment remains 'TBC' the proposed measurement unit is 'average number of spills per overflow', reported to two decimal places over a calendar year.

We seek clarity on the strict definition of 'average number of 20 spills'. Can Ofwat please clarify whether this is;

- **Total number of spills based on event duration monitoring (EDM) data divided by the total number of overflows, to create a regional average of 20 spills over a calendar year, or**

- **Average number of 20 spills per calendar year for each individual overflow.**

Our intention is that this is the average number of spills across all of a company's overflows (i.e. total spills/total overflows) in a given year.

Outcomes: In appendix 6, section 6.8.2 (low water pressure) Ofwat state "While we do not propose a common performance commitment, if a company is delivering poor service, we expect the company to propose a bespoke performance commitment and we may impose one if it does not". We are seeking clarification which measures aside from low pressure are in consideration for Ofwat to introduce as bespoke PCs for poor performers.

Other measures may also be relevant, including, for example percentage of people on the Priority Service Register. It is for companies to propose a bespoke performance commitment where the conditions outlined in the section 5.2.1 of the draft methodology are met.

Scope of BioResources control: Figure 3.1 (Main document page 24) shows sludge treatment as part of Wastewater Network+ rather than as part of BioResources. Can you confirm this is an error?

A revised version of the main draft methodology document was published on 22 July 2022 to incorporate updated versions of figure 1.1 and figure 3.1.

Risk and Return: In appendix 8, section 5.1.3 Ofwat outline a proposal "that caps and collars are set at levels equivalent to ±0.5% RoRE for individual performance commitments". Please can you clarify if this is an annual figure or a level at which caps / collars would be set over the 5 year AMP period?

Yes, this is intended to be on an annual basis.

Risk and Return: In appendix 8, section 5.1.3 Ofwat outline a proposal "that companies can earn or incur up to +3% or -3% RoRE without any sharing of payments". Please can you clarify if this is an annual threshold or if it is a threshold at which payment sharing occurs over the 5 year period.

Yes, this is intended to be on an annual basis (see page 47 of appendix 8).

We are asked to consider two scenarios in our business plan, one where a national social tariff has been implemented, and one where it has not yet been implemented. Can we clarify that if the national social tariff has been implemented, could companies propose a further tariff to help customers who previously had been on the company tariff but now do not qualify for the national tariff?

This is a good question and one we will need to come back to, as policy work led by Defra and Welsh Government on a single social tariff develops, potentially in the final methodology that is due by the end of the year.

Ofwat mentions that in April 2023 companies are to submit proposed definitions for bespoke performance commitments. The high-level timeline indicates that there will be an early submission of cost claims and ODI's in May. Please can you clarify the scope of the April PC and May ODI submissions.

and

Please can Ofwat confirm when companies will be required to provide proposed definitions for bespoke performance commitments. In the revised timetable on page 10 of the consultation document it says May 2023 whereas on page 59 it is April 2023.

The submission date is April 2023. We will update the next steps diagram to reflect this. The scope is for bespoke PC definitions only, not for PCLs or rates.

It appears to us that functionality within the draft financial model has been reduced from the PR19 FD model by removing the calculations that enable the selection between reducing balance depreciation of RCV Run-off and straight line depreciation. This change was not covered in the released methodology documents and we notice that there is an abbreviation for 'straight line method' included on the list shown on the 'Map & key' tab within the draft financial model. Is this functionality still to be added to a future version of the updated model or has there been a change in policy around RCV depreciation that does not allow straight line depreciation to be used; in the case of a policy change can you please clarify why this decision was taken.

Thank you for bringing to our attention the reference to the straight line method on the map and key. We will remove this in the final model. We plan to maintain the single reducing balance approach to RCV depreciation as set out in the draft financial model. The financial model allows companies to propose different RCV run-off rates across the years. RCV run-off rates should be within the constraints of the narrow band we propose to set out in the final methodology, and should be supported by sufficient and convincing evidence that the rates provide an appropriate allocation of costs between different generations of customers

With regards question 5.1 of the PR24 draft methodology:

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

Page 58 refers to a proposal 'that performance commitments designed to reduce water demand should cover business customer demand, in addition to leakage and household customer demands (per capita consumption).'

Please could Ofwat clarify if question 5.1 should include business demand?

Yes, question 5.1 should refer to business demand rather than household and domestic consumption. We will update in the published document.

PR24 draft methodology stakeholder Q&A: Batch 2

10 August 2022

Cost assessment: Appendix 9 s.2.3.6 sets out that cost adjustment claims should show how an upward adjustment to the cost allowance for the claiming company would impact the allowances of all other companies. These may be positive or negative. Where a CAC is allowed, would all those allowances for other companies be applied automatically (subject to any adjustment by Ofwat in assessing the claim)?

It is difficult to give a definitive answer to this question until we see the evidence presented. But we expect cost adjustment claims to be symmetrical where the claim relates to costs incurred historically and subsequently included in our modelled cost baseline, as set out in Section 2.3.6 of Appendix 9.

Companies will also have the opportunity to consider and comment on other companies' proposed cost adjustment claims in their PR24 business plans following the cost claim publication in summer 2023.

Developer Services Revenue Adjustment (DSRA). It is unclear from appendix 3 (page 10) the scope of the DSRA being proposed. Can Ofwat confirm whether this scope includes growth driven investment at Water Recycling Centres as per the CMA PR19 Redeterminations?

We welcome views on this in response to the draft methodology.

We have purposefully not commented on this in the draft methodology. It is difficult to confirm the scope of the DSRA until we have decided our approach to assessing investment at Water Recycling Centres (ie separate assessment or part of base costs) and our approach to regulating developer services at PR24 (ie inside or outside of price control).

Developer Services Revenue Adjustment (DSRA). It is unclear from appendix 3 (page 10) what Ofwat mean by change of “mix of work”. Can Ofwat clarify whether this means the complexity of work undertaken (i.e. on site versus offsite reinforcement) or whether this mix refers to the split of work undertaken by water companies versus third parties?

As set out on page 10, this largely relates to the complexity of work undertaken. For example, the work required to connect a new development to the water and wastewater network will be site specific.

The use of a single unit rate for each company in the DSRA means that companies have an incentive to give away more costly development sites to third parties (self lay providers and new appointees).

We have a clarification whether the recently requested sector datasets in relation to growth and developer services (part of the suite of 6 additional data requests from companies during July and August 2022) would form part of the Autumn dataset shared with companies? We consider these would be beneficial in exploring opportunities for developing growth based modelling approaches, which we have positively contributed to through our CAWG engagement.

As clarified in response to a query to the cost assessment inbox, this is still to be decided. Our current view is:
- Data request 6 – developer services site specific information is unlikely to be published due to potential data confidentiality issues. Some data gaps may also prevent use of data for cost modelling purposes.
- Data request 7 – we aim to publish the growth expenditure data as part of the base modelling data set in Autumn 2022 if the data is of sufficient quality.
- Data request 8 – unlikely to be published as part of the base cost modelling data set as we only expect to receive the data in late August 2022. We may publish the data at a later date.

PR24 business plan incentives have a range of financial adjustments equivalent to +/- 30 bps return on regulated equity W(RoRE). Can Ofwat confirm whether this +/- 30 bps RoRE adjustment is based on notional or actual regulated equity? Will this +/- 30 bps RoRE adjustment be applied over one year or each year of PR24 five years? If it is calculated over one year's regulated equity, which year will it be?

The financial reward or penalty for the business plan incentive applies over the whole of the five-year price control period. This means companies would receive a basis point adjustment in each year of 2025-30, eg a company that achieves a + 30 adjustment would receive a 30 basis point uplift each year. The £m value of the adjustment will be calculated on the basis of notional regulatory equity.

If a company has carbon reduction related investment across all four categories (base, standard enhancement, net zero enhancement and net zero challenge) would they be treated as bespoke PCs?

Section 5.2.1 in Appendix 9 explains our proposed approach to GHG emission reduction funding and incentives. We intend that all funded net zero benefits will be accounted for in company performance commitment levels (eg base, standard enhancement, net zero enhancement and successful challenge bids where applicable). We propose separate common PCs for operational GHG emissions for wastewater and water services that take account of the impacts of all relevant investment.

Does the 30bps reward / penalty for the business plan incentive apply for one year of the 2025-30 period or all five years?

The financial reward or penalty for the business plan incentive applies over the whole of the five-year price control period. This means companies would receive a basis point adjustment in each year of 2025-30, eg a company that achieves a + 30 adjustment would receive a 30 basis point uplift each year.

Does the business plan incentive have 5 or 6 tests? I.e. are costs and outcomes separate tests or a single test? (The diagram in the draft methodology shows 5 tests, but the webinar slides shows 6 tests).

The quality component of the business plan incentive assessment has separate components for costs and outcomes and the proposed minimum expectations for each area are specified in chapter 11 and appendix 12. When we assess ambition we will consider whether companies propose stretching but achievable service levels at an efficient cost to customers and so we intned to consider costs and outcomes together. The webinar diagram represents the scope of the quality assessment only, whereas the draft methodology diagram represents the scope of the quality and ambition assessments.

On assurance the documents refer to the 'level of assurance'. For example, 'we expect companies to specify the level of assurance obtained and why the board considers this to be appropriate'.

Separately, they say, 'we expect boards to be able to provide unqualified assurance…'

What does this mean please – limited vs reasonable; qualified vs unqualified, something else? We would like to be clear for the avoidance of doubt.

It is up to companies to determine how they carry out their assurance of Board statements that business plans are financeable under the notional structure and that business plans are set in the context of allowing them to maintain financial resilience over 2025 to 2030 and beyond. This should relate to each company's own circumstances. However, companies may consider it is appropriate to obtain third party assurance of the statements under a set of agreed upon procedures.

Appendix 9, section 6.1.2 states the following:

'The water industry national environment programme options development guidance provides recommended values for a range of environmental and social outcomes. Where the collaborative outcome delivery incentive rates research cannot be used to derive a monetary value, companies should use this guidance.

For some outcomes, the water industry national environment programme guidance may provide more than one recommended value. These are not confidence intervals but rather context-specific values.

Therefore, we expect companies to apply the recommended values appropriately for the situation being assessed and to provide a robust justification for this.'

We cannot see these values in the link provided in the footnote and would appreciate some clarifications.

Footnote 159 should reference the 'WINEP Options Development Guidance' , published by the EA and last updated in July 22. In section 7.3.1 of this document it provides information on wider environmental outcomes metrics. Within this section there is also a link to the 'Wider environmental outcomes metrics' spreadsheet which contains more specific details.

Water companies have access to these documents which have been issued by the EA.

For bioresources will legacy assets be excluded for the application of the frontier shift?

We are not proposing to exclude legacy assets from the frontier shift. This is consistent with the degree of regulatory protection we propose for pre-2020 RCV.

Tables LS3/LS4 - Should table LS3 be the same as table CW13?

Should table LS4 be the same as table CWW13?

No in both cases – as set out in our business plan table guidance, cost figures in tables CW13 and CWW13 should reflect enhancement expenditure for schemes that will commence in 2025-30 period only. Tables LS3 and LS4 should reflect enhancement expenditure for schemes that will commence in 2025-30 period **and beyond (up to 2050)**.

PR24 draft methodology stakeholder Q&A: Batch 3

23 August 2022

In the "Proposals for areas of specific board assurance" one of the areas listed in the "Long-term delivery strategies". The final guidance on long-term delivery strategies (in section 3.6) lists a number of expectations for the Board assurance statement. Amongst other things it expects that the Board "has challenged and satisfied itself that the strategy...will enable the company to meet its statutory and licence obligations, now and in the future." Long term delivery strategies will inevitably consider factors exogenous to management, so how does this affect Board assurance and sign off? In other words, could Ofwat please clarify how they expect Boards to sign off that the strategy will enable the company to meet its statutory and licence obligations, now and in the future, when such a statement would require knowledge and foresight of future uncertain events?

Long-term delivery strategies should support the delivery of long-term outcomes as efficiently as possible, given the information available at the time. We expect companies to present strategies that are demonstrably robust to key future uncertainties. We do not consider this requires knowledge or foresight of future events, as strategies should consider a full range of plausible futures. We consider that strategies will need to be modified to some extent in future, taking into account new information and circumstances. (As set out in Ofwat, 'PR24 and beyond: Final guidance on long-term delivery strategies', April 2022, Chapter 5, p. 46.)

It is a company's duty to ensure that it maintains an efficient and economical water supply and a sewerage system to effectually drain its area and effectually deal with the contents of those sewers. The company Board should provide an assurance statement that explains how it has challenged and satisfied itself that the strategy represents the best possible strategy to efficiently deliver its stated long-term objectives including all its statutory and licence obligations, given future uncertainties. It is for the companies and their Boards to determine how best to provide this assurance, including the role of external assurance.

Under "Long-term delivery strategies" Ofwat state "In early 2023, we will provide a voluntary opportunity for companies to receive high-level feedback on the development of their long-term delivery strategies. We will invite companies to present a summary of how they are developing their long-term delivery strategy."

Could Ofwat please clarify whether the long term delivery strategies is for enhancement and statutory programmes as per the previous LTDS guidance, not the whole of a company's plan and 25 year strategy?

As set out in our final guidance, we expect the adaptive pathways in the long-term delivery strategy to focus on the requirements for enhancement expenditure to meet the company's ambition. (Ofwat, 'PR24 and beyond: Final guidance on long-term delivery strategies', April 2022, p. 18.)

Base expenditure will contribute towards this ambition, and companies should explain in their accompanying narrative how their approach towards asset management will help meet long-term objectives. (Ofwat, 'PR24 and beyond: Final guidance on long-term delivery strategies', April 2022, p. 31.)

Companies should also forecast long-term performance improvements from base expenditure, taking account of our approach to setting performance commitment levels as set out in the PR24 draft methodology. (Ofwat, 'Creating tomorrow, together: consulting on our methodology for PR24, Appendix 9: Setting expenditure allowances', July 2022, Chapter 4, pp. 65-84.)

The Best Value Calculation as set out in Appendix 9 Section 6.1.3 sets out that: "Capex should be should be converted to a stream of annual costs for the duration of the appraisal period, where the annual cost is made up of depreciation costs plus the allowed return on capital".

Can Ofwat please clarify that this is different to the Spackman approach (which the EA has asked companies to use in the WINEP Options Development Guidance)?

The methodology set out in in Appendix 9, Section 6.1.3, on how to treat capex when calculating benefit to cost ratios is consistent with the approach set out in section 8.3.1 of the WRMP guidelines on calculating net present costs and benefits. This establishes that finance costs should be calculated as a stream of annual costs over the life of the option, where the annual cost is the cost of financing the net book value of assets that contribute to the RAV, adjusted for straight line depreciation, using the assumed WACC in PR19 determinations. It is also consistent with the Spackman approach set out in Section 7.4.3 of the WINEP Options development guidance which establishes that investments should be converted to a stream of depreciation/RCV run-off costs and allowed returns over the life of the assets.

We seek clarification on Ofwat's intention to track embedded GHG emission reduction through bespoke PC or PCD. In the consultation document Appendix 6 (section 6.9 embedded GHG emission, page 76) Ofwat 'encourage companies to consider whether a bespoke performance commitment could deliver significant benefits to its customers'. In Appendix 9 (page 99), Ofwat 'expect the delivery of all funded embedded emission reductions to be appropriately tracked, most likely through a price control deliverable (PCD).'

We consider that a robust performance commitment measuring embedded GHG emissions for which stretching performance commitment levels can be set would be the most effective way to monitor and incentivise progress in reducing embedded GHG emissions. Where a company is unable to measure GHG emissions in a robust and consistent way over the period up to 2030 and/or we are unable to set stretching performance commitment levels we expect that PCDs will be used to track improvement.

We would like to clarify whether Ofwat expect to share valuations for all common PCs by Winter 2022-23, including those not being directly covered in the collaborative research like asset health, biodiversity, operational GHG emissions. In the main draft methodology document (page 61), it says 'We expect to publish initial customer valuations from the collaborative research in autumn 2022, with valuations mapped to common performance commitment definitions by winter 2022-23.'

We currently intend to only share indicative ODI rates for PCs covered by the collaborative customer research.

Appendix 6, 4.1.2 - In this Biodiversity section Ofwat state: "we are grateful for the time and commitment given by the biodiversity performance commitment task and finish group members... We expect to reconvene this group to assist with determining the details of the performance commitment definition." At the PR24 draft methodology webinar on 'Delivering outcomes for customers' it was confirmed that a an additional task and finish group on River Water Quality would commence in July/August and continue into September. Could Ofwat please provide further details on when the biodiversity task and finish group will take place?

The Biodiversity task and finish group last met on the 28th July '22, a further meeting has not yet been scheduled, but the group will continue in September.

Please can you clarify the timeline and more guidance about when the efficient unit cost of carbon reduction will be set and how will it be determined? Specifically in relation to the timing of when companies will be

submitting plans relative to when you will reveal your view of the efficient cost of carbon reduction.

Company net zero enhancement requests submitted in business plans will be assessed and form part of the evidence base for setting an efficient unit rate for carbon reduction. The outputs of this will be included in the draft determination.

Will the net zero challenge fund be run to the same submissions dates as the main PR24 submission?

Yes.

Are bioresources related greenhouse gas emission reductions within the scope of base/standard/net zero enhancements and the challenge fund?

Yes, bioresources related greenhouse gas emissions fall within the scope of reductions we expect at PR24.

Ref LTDS data tables. How do you want us to capture the carbon benefits of the core and alternative pathways (in either tC02e or expenditure) relating to any enhancement investment for the standard enhancement, net zero enhancement and net zero challenge?

Companies should use table LS1 to set out the forecast performance commitment levels that will be delivered by their entire strategy, in line with their long-term ambitions. This includes the estimated impact on operational greenhouse gas emissions. The PR24 common performance commitments will be confirmed in the PR24 final methodology. As set out in the final guidance on long-term delivery strategies, the strategy should include forecasts against all PR24 common performance commitments, except those based on compliance or relative performance.

Page 27 of the final guidance on long-term delivery strategies asks companies to set out evidence that the strategy delivers their long-term ambitions under each of the common reference scenarios. This should show that, under each scenario, the strategy achieves the performance commitment levels set out in table LS1. This evidence should be set out in the strategy rather than the data tables. If the trajectory to meeting the ambition is significantly different under certain alternative pathways, this should also be highlighted in the strategy document.

For the common PC on operational greenhouse gas emissions Ofwat mentions water and wastewater. Are bioresources emissions part of the wastewater PC on operational greenhouse gas emissions?

Yes.

Does the limit of 2-3 bespoke ODIs apply to each company or each service, so that water and sewerage companies could have more bespoke ODIs than water only companies?

The figure is purely an indicative number. If there is an area that is important to customers, and is not covered by other PCs, we encourage companies to propose a bespoke PC if it meets our criteria for bespoke PCs. We discourage companies from submitting bespoke PCs that do not meet these criteria. Companies should have no bespoke PCs if not required, but where there is compelling evidence that more than 3 bespoke PCs are required these should be proposed.

Re DPC, in appendix 5 it talks about whether incumbents can submit competing bids. We wanted to clarify – do you mean incumbents providing a bid for the project/need in their own region, or incumbents bidding for work in other regions (or indeed both)?

This refers to the current policy which is to exclude companies from bidding for projects in their own region.

Net zero targets and investment – We find it difficult to interpret the intentions for base and enhancement expenditure in this area. In appendix 9 (figure 5.1) the level of performance expected in "Base expenditure reduction" and "Net zero enhancement reduction" both refer to common targets – are these expected to be the same common target (i.e. jointly to be delivered from base and enhancements), or separate targets/reductions in GHG emissions? If the latter, then how will each common target be assessed?

As described in Appendix 9 Section 5.2.1 all the funded net zero benefits will be accounted for in company performance commitment levels (eg base, standard enhancement, net zero enhancement and successful challenge bids where applicable). We propose a common level of GHG emissions will be achieved from base allowances. This will then be adjusted to account for the impacts of standard enhancement investment with the potential to benchmark companies to compare ambition and set a minimum expectation. From the long list of net zero specific investments presented by companies further reductions should be identified and presented to enable a standard percentage reduction to be funded for each company. The schemes presented that take companies beyond these levels will be considered as part of the industry net zero challenge.

Developer Services site specific work - within Appendix 3, Ofwat discusses 'site specific' work coming out of the Network Plus price controls. In Ofwat's previous RFI requests, site specific costs have been restricted to construction work on a developer's site, with other related costs (e.g. admin, application fees, and indirect costs) separately classed as "Other developer services activities". However, we believe that Ofwat's intention would be that costs and developer charges related to all developer activities that a company undertakes excluding offsite work (i.e. excluding network reinforcement etc.) Therefore, the 'site specific' work referred to in this methodology consultation includes all of:

- **Construction work**
- **Admin activities and charges**
- **Application fees**
- **Costs to be inclusive of overheads**

Can Ofwat confirm its intention for the activities and costs to be excluded from the Network Plus price controls?

That intention is correct. We will work with companies to ensure that developer services expenditure and revenue data is reported correctly and consistently. We are currently engaging with companies on this issue through the Annual Performance Report query process.

Data tables and long term strategy – we note that table LS4 appears to cover both Wastewater Network Plus and Bioresources, and that there is no separate equivalent table for Bioresources. Are we correct to assume that this table is intending to cover both WwN+ and Bioresources?

Yes, table LS4 covers enhancement expenditure for both wastewater network plus and bioresources.

Sludge liquor recharges - Our understanding is that sludge liquor charges from Wastewater Network+ to Bioresources are only being shadow reported for AMP7 and then implemented from AMP8. The "PR24-BP-table-guidance-part-06-Bioresources" document states for BIO3.17 that "… sludge liquors are being shadow reported for AMP7 and AMP8." Can Ofwat please clarify whether

that shadow reporting only applies to AMP7 and the definition for BIO3.17 is in error or whether, alternatively, BIO3.17 is correct that shadow reporting applies for both AMP7 and AMP8?

In our guidance on "Reporting of sludge liquor treatment costs – final decisions" p. 7 we state the following:

"Implement the standard methodology developed by Jacobs for reporting year 2021-22. Companies should shadow report the cost of internal recharges for liquor treatment based on this until the end of Asset Management Plan period (AMP) 7, in order to avoid material financial impact resulting from a mid-AMP change. The methodology should be fully implemented from AMP 8 onwards".

Thus, the shadow reporting requirements only applies for AMP7, and the updated reporting requirements should be followed from AMP8 onwards. We recognise that there is an error in the current version of "PR24 business plan table guidance part 6; Bioresources" and will correct it in the updated version.

Please could Ofwat clarify the expenditure classification of _inv drivers in the WINEP. There are several _inv drivers that the Agency have asked us to build costs for e.g. 'WFD_inv mp – Investigations and trials into upstream catchment and treatment initiatives to reduce micro-plastics entering the environment via wastewater pathway' and 'Env Act _inv 4 - Investigations to reduce storm overflow spills to protect the environment so that they have no local adverse ecological impact as two examples.'

Can Ofwat please clarify whether these are to be opex or capex in the submission and the relevant RAG, noting that there is allowance for both capex and opex for investigations in submission table CWW3.

Similarly, please can Ofwat clarify the general principle to expenditure classification for Sustainable Urban Drainage Systems (SUDS) and again the relevant RAG.

The definition for the Investigations Lines CWW3.73-75 (RAG 4M73-75) is provided in the published: 'BP-table-guidance-part-4-Costs-wholesale-wastewater', as follows:

'Expenditure on investigations and/or options appraisals listed in the WINEP/NEP (driver codes INV and NDINV) to confirm / identify actions / determine impacts or the costs and technical feasibility of meeting required targets, unless the investigation is listed elsewhere in this table (specifically under driver codes WFD_INV_CHEM & WFD_INV_MP)'

Investigations under the Chemicals and Microplastics WINEP driver codes should be entered in CWW3.31-3.33 (RAG: 4M3.33-35) as defined in the same document. Investigations for the WINEP Technically Achievable Limit should also be included separately in lines CWW3.73-75 (RAG4M3.73-75) as described in this document.

The decision whether to input to capex or opex will be based on the company's own accounting policy, and the nature of the Investigation. Previous information is available in published APRs for all companies.

Expenditure on Sustainable Urban Drainage Systems (SUDS) is covered in the same document and submission tables. Dependant on the driver being addressed SUDs expenditure could come under lines CWW3.16-18 or CWW3.22-24. Information should also be entered in RAG4M and CWW20.

We asked a clarification question in the setting expenditure allowances webinar led by Ofwat. The answer received suggests that companies enhancement spend will be accounted for in the common commitment for net zero. The approach for other PCs is that base allowances determine the common PC and then these are adjusted for approved enhancement schemes that impact the PC. Please can you clarify whether the process is indeed different to the other PCs, and then how we will determine bids to go further than the common PC without knowing the common PC in advance of submission?

As described in Appendix 9 Section 5.2.1 all funded net zero benefits will be accounted for in company performance commitment levels (eg base, standard enhancement, net zero enhancement and successful challenge bids where applicable). For companies with the most ambitious and efficient net zero plans we will consider bids on a competitive process, looking at which companies have the most efficient costs and provide those with more funding based on the additional amount asked for.

Are companies expected to put forward bespoke ODIs as part of showing ambition?

Ambition is about doing the most for your customers in the areas they care about. This is therefore likely to include proposing ambitious performance commitment levels on common PCs. Not proposing bespoke PCs will not be seen as unambitious in the business plan incentives (BPI) assessment if they are not required. If there is an area that is important to customers, and is not covered by other PCs, we encourage companies to propose a bespoke PC if it meets our criteria for bespoke PCs. We discourage companies from submitting bespoke

PCs that do not meet these criteria. If they are not required, bespoke PCs are not needed to reach the top category in the BPI assessment.

Table OUT3 - Please could you clarify how this table will be calculated from CW15/CWW15. Is the forecast in 2024/25 in relation to enhancements that we have included in the transition programme? If it is, should the table also include 2023/24 for any enhancements that relate to WINEP obligations?

Tables CW15 and CWW15 capture the benefits from each enhancement expenditure line resulting from investments commencing in the 2025-30 period. These benefits are captured in terms of individual performance commitments. In table OUT3 for each year the total benefits delivered across all the enhancement expenditure lines for each individual performance commitment will be aggregated. The total benefits captured in tables OUT2 (delivered by base) and OUT3 (delivered by enhancement) should reconcile with the trend presented in OUT1 Which includes the combined impact of base and enhancement expenditure. We will review the requirement for inclusion of pre-2025-26 figures in tables OUT2 and OUT3 as part of our development of our final PR24 methodology.

Table CW13 - Does this table relate to the best value plan or the core pathway?

If the table relates to the best value plan, would you like us to include the costs of the best value plan even if that isn't the total in CW1? Should we exclude transition spend?

This table relates to the enhancement schemes included in the company's business plan. In principle, these schemes should constitute the company's best value plan under its core pathway. The 2025-30 costs in this table should match those in table CW3. This means that any transition spend associated with schemes commencing in the 2025-30 period should be included in the 2025-30 period and not in 2024/25 as specified in our PR24 submission table guidance. This transition spend should also be reflected in the values submitted in the "Present value of costs" columns, assuming the same profile of spend as assumed for the transition spend included in the 2025-30 period.

Tables LS3a-g/LS4a-g - Does "change in totex" mean relative to the core pathway in each case? The waste equivalent tables seem to ask for total totex rather than the "change."

Tables LS4a-i should ask for the "change in totex" consistent with tables LS3a-i and as set out in our PR24 submission table guidance – section 9: Long-term strategies. This will be corrected in the data tables published alongside the final methodology.

In tables LS3a-i and LS4a-i the change in totex should always be calculated relative to the core pathway.

Table LS7 - Does this table relate to households or an average across households and non-households?

Table LS7 should reflect household bills only. This is explained on page 65 of the final guidance on long-term delivery strategies: 'The bill impact per year should be total long-term revenue requirement recovered from household customers divided by the number of household customers.'

PR24 draft methodology stakeholder Q&A: Batch 4

31 August 2022

Business Plan incentives: In Appendix 12 Ofwat outline that the direct financial rewards for companies assessed as "Outstanding" will be " + 30 bps return on regulated equity over the entire price control period" (page 10). We are assuming this means that total value of the incentive is 30 bps on RORE calculated each and every year of AMP8. Can you confirm this is correct and provide an example calculation?

The financial reward or penalty for the business plan incentive applies over the whole of the five-year price control period. This means companies would receive a basis point adjustment in each year of 2025-30, eg a company that achieves a + 30 adjustment would receive a 30 basis point uplift each year. The £m value of the adjustment will be caclualted on the basis of notional regulatory equity.

Illustratively, if a company with notional regulatory equity worth £1000 m received a reward of + 30 bps and took this as an adjustment to revenue then it would be allowed to recover an additional £3m from customers in each year of 2025-30. This would be worth £15m in total between 2025-30.

Ref Appendix 9.5.2.1 and Appendix 6.4.2.2. Given that achievement of net zero by 2050 will include offsets (and insets), how will the common performance commitment for baseline emissions take into account offsets? (also with ref to p.36 of Frontier Economics Report)

We consider that the PC for baseline emissions will exclude offsets and insets as we do not expect them to play a role between 2025-30. We propose that companies will detail the impacts of offsets and/or insets beyond 2030. We ask companies to be clear about their gross operational emissions, with reductions in emissions being delivered in relation to that baseline.

Please can you clarify your definition of operational greenhouse gas emissions in terms of scopes and categories. In particular, Appendix 7, section 3.2.2 makes reference to Scope 3 all indirect emissions. Do you have a defined set of Scope 3 emissions that you would like to see reported beyond those already included in the annual operational greenhouse gas reporting?

Operational GHG emissions should be defined in line with the activity areas included in our operational greenhouse reporting, particularly in relation to Scope 1 and 2 emissions. We recognise that our current approach to the reporting of Scope 3 emissions is only partial. There are a core number of activity areas being listed. We do not anticipate prescribing additional areas for action within Scope 3.

Ref Appendix 4 bioresources. Is it intentional that the bioresources data table doesn't ask for operational greenhouse gas data? If so will the wastewater greenhouse gas target also include bioresources assets?

The bioresources data table should ask for operational greenhouse gas emissions data.

Are companies expected to include all bioresources related greenhouse gas emissions as part of their bioresources cost forecasts?

Yes, companies are expected to include all bioresources related greenhouse gas emissions as part of their bioresources cost forecasts.

Financial Testing Scenarios – Re: question Q9.1, we interpret the "increase in the level of bad debt (20%) over current bad debt levels……." as representing a 20% increase in the absolute level of £m bad debt (e.g. from 5% to 6% of revenues) as opposed to a 20% increase in the proportion of revenue (e.g. from 5% to 25% of revenues.) Can Ofwat clarify whether we are correctly interpreting this requirement?

We can confirm your understanding is correct. We propose a 20% increase in the absolute level of £m bad debt.

With the removal of the IAP (Initial Assessment of Plans) stage from PR19, our working assumption is there will be sufficient time allowed for post draft determination to develop our final business plan. Could you please indicate the time window that will be provided post draft determination before final business plan submission to allow us to effectively manage resources over the summer of 2024.

We will publish more detailed milestones as part of the final methodology in December 2022.

On the risk and return appendix: Annex B from page 45 it sets out the impact of fully transitioning to CPIH which in the short term brings cash forward and boosts financial metrics. It also sets out the impact for each company if applied to PR19 Determinations. Table 11.1 shows the improvement in our interest cover ratios but in table 11.2 it shows that South Staffs average bill

would be lower which we're not sure why if you could please clarify as we are the only company shown in that position.

To calculate the impact of fully transitioning to CPIH we have assumed that 100% of RCV at 31 March 2020 is CPIH-RCV in the PR19 final determinations. In the case of South Staffs Water, the RCV run-off rates applied to CPIH-RCV were lower that the RCV run-off rates applied to RPI-RCV in the company's final determination. Switching all RCV to CPIH results in lower RCV run-off revenue and lower Appointee revenues overall, hence resulting in a decrease to the average bill. We provided these figures for illustrative purposes only and in reality, we may expect the company to maintain its overall RCV run-off revenue.

Appendix 6.4.2.2 and Appendix 9.5.2.1. The methodology is clear that we should prioritise cutting emissions rather than offsetting. The example given is Nature Based Solutions that could reduce energy and chemical usage. Such assets would also have the ability to absorb carbon – as might other nature-based assets that companies might choose to deliver on their estates. With this in mind, Is there a distinction to be made between offsets that companies deliver for themselves and offsets that a company could choose to buy-in from elsewhere ?

We expect proposals at PR24 to focus on cutting emissions rather than delivery of offsets. The example used was to highlight that some standard enhancement activities eg nature based solutions such as SUDs to address sewerage network storage issues, can also support GHG emission reductions. Given the focus is on reducing emissions there is currently no hierarchy for offsets in the methodology as we do not expect them to feature in PR24 for 2025-30.

PR24 submission table guidance – Section 2: Risk & Return. Section 27, page 54

RR25:13 Should "ratio of embedded debt to new debt" read "ratio of embedded debt to total debt", in order to make the calculations in the table work?

We can confirm this should be "ratio of embedded debt to total debt"

PR24 submission table guidance – Section 2: Risk & Return. Section 28, page 56

RR26:14 Should "ratio of embedded debt to new debt" read "ratio of embedded debt to total debt", in order to make the calculations in the table work?

We can confirm this should be "ratio of embedded debt to total debt"

Summary tables – tables guidance. PR24 submission table guidance – section 11: summary tables, p. 4.

Could you clarify the difference between what will be presented in SUM1 (Performance commitments) and SUM7 (Performance measures)?

Page 4 provides a summary of the information we expect to include in this table – at this stage we are unable to provide a more detailed level of content but you can of course include suggestions of your own in your consultation response.