

December 2022

Creating tomorrow, together:  
Our final methodology for PR24

# Appendix 1

## Affordability

## About this document

This appendix sets out our approach to affordability at PR24.

First, it explains the context to affordability in PR24 and the different dimensions of affordability we consider. It sets out our consideration of stakeholders' responses to our draft methodology. It explains how we propose to treat social tariffs in PR24 and reporting on customers struggling to pay. It then explains the main policy tools we will use at PR24 to address affordability, and how this is complemented by our wider toolkit.

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## 1. Introduction

Affordability in the water sector is the ability of a customer to pay their water bill. For PR24, companies 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 their bill.

PR24 is our primary tool for regulating companies to deliver overall affordability, value for money, and affordability for current and future customers. We also use our wider toolkit outside of PR24, particularly to support customers struggling to pay their bills.

After this introduction, section 2 sets out stakeholders' responses to our draft methodology. Section 3 explains how we propose to treat social tariffs in PR24 and reporting on customers struggling to pay. Section 4 sets out the main policy tools we will use at PR24 to address affordability. Section 5 explains how this is complemented by our wider toolkit.

### 1.1 The importance of affordability in water regulation

Delivering affordable bills is one of the key challenges the sector needs to address through PR24. This is particularly the case because major new investments required as part of PR24 will create upward pressure on bills over and above the impact of inflation.

In June 2022, research by the Joseph Rowntree Foundation highlighted that some 7 million low-income households were going without at least one essential (such as a warm home, enough food, appropriate clothing or basic toiletries) and over 2 million families were neither eating properly nor heating their home adequately.<sup>1</sup> Our cost of living report looked at customers' experiences with household bills, particularly water bills over the last year. It revealed that half of water bill payers struggled 'sometimes', or most or all of the time to pay household bills. Two-thirds of bill payers expect their financial situation to get worse over the coming year.<sup>2</sup> CCW conducted qualitative research with customers ahead of publishing its report on objectives for PR24; it reported customers' top priorities related to affordable bills in exchange for clean, reliable water.<sup>3</sup>

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<sup>1</sup> Joseph Rowntree Foundation, '[Not heating, eating or meeting bills – managing a cost of living crisis on a low income](#)', June 2022.

<sup>2</sup> Ofwat, '[Cost of living: wave two - Water customers' experiences](#)', December 2022.

<sup>3</sup> CCW, '[Delivering for customers at PR24: CCW's objectives for the 2024 Price Review](#)', May 2022. See also CCW, '[PR24 Objectives: Yonder debrief](#)', May 2022.

Affordability is an important issue for both the UK and Welsh governments, as reflected in their respective strategic priorities and objectives for Ofwat.<sup>4 5</sup> Our statutory duties include a need to further the consumer objective, including the need to have regard to the interests of low-income consumers.<sup>6</sup> Having due regard to our Public Sector Equality Duty, we expect companies to understand and respond to the diverse needs of their customers.

The importance of delivering affordable business plans underpins each of the ambitions we have identified for PR24: increasing focus on the long term, delivering greater environmental and social value, reflecting a clearer understanding of customers and communities and driving improvements through efficiency and innovation.

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<sup>4</sup> Defra, '[The government's strategic priorities for Ofwat](#)', 28 March 2022. For example, the UK government's SPS states that "...it will be vital that support is in place for those who may struggle to afford water bills", and that "Ofwat must consider the affordability of bills for the generality of customers, as well as requiring that water companies have protections in place to support households who struggle with their water bills."

<sup>5</sup> For example, the [Welsh Government's strategic priorities and objectives statement to Ofwat](#) include challenging companies to deliver value for money for customers, communities and the environment, seeking to ensure that the timing of investment results in intergenerational equity, and challenging companies to provide effective support to customers who are struggling to pay.

<sup>6</sup> The general statutory duties for most of our work as an economic regulator are set out in section 2 of the [Water Industry Act 1991](#).

## 2. Stakeholder views

A broad range of stakeholders made comments and observations on affordability in responses to our draft methodology, including most water companies and some customer representative groups.

Many companies and other stakeholders noted the scale of affordability challenges facing households, especially given increasing cost of living pressures. Some responses highlighted challenges specific to their area. This included Dŵr Cymru who noted the relatively high prevalence of economic deprivation in Wales and an independent challenge group that highlighted poverty levels in parts of London. CCW said that water affordability is the defining issue of the price review and stressed the importance of having adequate protections in place to shield financially vulnerable households from unaffordable bills.

Some companies suggested that the costs of statutory elements of business plans are likely to have a significant impact on bills, and that this comes at a time when there are cost of living challenges. Northumbrian Water suggested that, in the context of affordability, there is a potential conflict between customer views and statutory requirements. Many companies noted the tension in PR24 business plans between delivering appropriately prioritised investment and ensuring that customers are protected from significant bill increases.

Some companies and customer representative groups, such as CCW, said that assistance for those who would struggle to pay is critically important if bills overall are to rise to fund investment. Social tariffs were noted as being helpful up to a point but some stakeholders, including Sustainability First and an independent challenge group, also encouraged focus on companies' role in tackling affordability beyond social tariffs, including through development of progressive charges and a wider package of support for those who may struggle to pay.

Some companies wanted more information about how the single water affordability discount scheme would be reflected in PR24 business plans given that the form and timing for its implementation remain unclear. Some companies asked that Ofwat be explicit about what companies should model to ensure consistency across the industry, particularly if detail on the design of the scheme remained unavailable by the time of the final methodology.

Some stakeholders were concerned that our streamlining of performance commitments at PR24 would mean less prominent reporting of affordability and vulnerability information in future. We respond to these comments in [Appendix 7 – Performance Commitments](#).

## 3. Social tariffs and support for customers struggling to pay

### 3.1 Social tariffs scenarios in business plans

Social tariffs are a key policy by which companies can support customers struggling to pay. This section sets out our approach to how social tariffs are reflected in companies' business plans.

The UK and Welsh governments are considering the role for, and potential form of, a single water affordability discount scheme, following on from the recommendation made by CCW in its independent water affordability review. CCW recommended a new mandatory scheme with universal eligibility criteria and a standard approach to determining levels of support.

To better fit in with the timing of work on a single water affordability discount scheme, we are not specifying requirements for social tariffs in companies' business plans in our final methodology, but plan to do so alongside a later version of the PR24 data tables which will be issued in 2023.

Subject to that confirmation, we anticipate that each company should cover two social tariff scenarios in its business plan. The distinction between scenarios will be reflected in only a small number of PR24 data tables and associated commentary, specifically relating to social tariffs and associated metrics.

The first scenario would be no change to the regulatory and legislative arrangements for social tariffs. Companies' business plan submissions would be compliant with the current legal framework, which includes having regard to existing government guidance on social tariffs. Consistent with existing guidance, we expect companies to engage with customers as they develop and implement social tariff arrangements, as well as consult with customer representatives which must include CCW.<sup>7</sup> This includes the provision of evidence that the proposed level of cross-subsidy has broad customer acceptability. We also set out our expectations that companies engage customers in [Chapter 4 of our final methodology](#).

The alternate scenario would be where a single water affordability discount scheme is introduced for or during the period 2025–30.

A mandatory scheme may include a country-wide fund to support households irrespective of where they live. In this form, the scheme may impact on each company's overall PR24 revenue requirement. Given that these impacts are multi-lateral, we would want them to be forecast on a consistent basis using parameters derived from an industry-led or government-

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<sup>7</sup> Defra, [Social tariffs guidance](#), 2012; Welsh Government, [Guidance in relation to social tariffs](#), 2013.

led process. As such parameters have yet to be established, we will not ask for these revenue impacts to form part of companies' business plan submissions.

We are continuing to work directly with UK government and Welsh Government regarding CCW's recommendation.

## **3.2 Reporting on support for customers struggling to pay**

We want companies to demonstrate ambition to enhance overall affordability, including for residential customers struggling to pay.

This forms part of the Quality and Ambition Assessment, which we set out in [Chapter 11 of our final methodology](#).

Companies should not wait until PR24 to act on affordability challenges. Our QAA in this area spans actions that companies are already doing or plan to do prior to 2025, including in relation to social tariffs.

To support our assessment of this aspect of companies' business plans, we will specify data tables relating to broader proposals for supporting customers struggling to pay their water bills through other methods of support. This may include, for example, the introduction of innovative charges. These will be additional to data tables on social tariffs. We will engage with companies on these tables prior to their inclusion in a later version of the PR24 data tables which will be issued in 2023. We anticipate that companies would provide commentary on their proposals and supporting evidence to accompany the tables.

## 4. Affordability in PR24

PR24 is our primary tool for regulating companies to deliver overall affordability, value for money, and affordability for current and future customers. Major new investments will create upward pressure on bills over and above the impact of inflation. In line with our ambitions for the price review, it is vital that companies support affordability at PR24 through:

- taking a long-term focus to reduce lifetime costs and phase investments over time;
- finding new ways of working, and working in partnerships to deliver more for customers;
- clearly understanding customers' views, including their expectations about bills today compared to the future;
- clearly understanding and supporting customers' diverse needs on a day-to-day basis, not just for a price review;
- balancing the recovery of costs between different generations of customers;
- reporting on how they support customers struggling to pay; and
- innovating and delivering a step change in efficiency.

We set out our key PR24 policies and actions in Table 4.1 below:

**Table 4.1 PR24 policies and actions to support affordability**

Area	Detail
<b>Long-term focus</b>	Increasing our focus on the long term in price controls, we expect companies to set out their five-year business plan in the context of a 25-year long-term delivery strategy. We will be looking for a core pathway of investments that are required to deliver outcomes efficiently under a range of scenarios and keep future options open, with clear trigger and decision points indicating where alternative pathways would be followed. We expect companies to: <ul style="list-style-type: none"> <li>• consider customers' views of how investments should be phased over time; and</li> <li>• explain how they have taken account of views on overall affordability, including how their strategy considers affordability in the long term.</li> </ul>
	A transparent and predictable regulatory regime encourages long-term investment, supporting affordability.
	Transparency in our regulatory approach, supported by evidence-led changes that are consulted on as they evolve over time, minimising the size of any regulatory risk premium in required returns, facilitates companies making efficient investment decisions over the long term.
<b>New ways of working</b>	To encourage new ways of working, we are encouraging partnerships between companies and other stakeholders, for example to implement nature-based solutions, to reduce costs to companies and support affordability.
	We will take into account third-party funding when we undertake our cost benchmarking, to encourage partnerships.

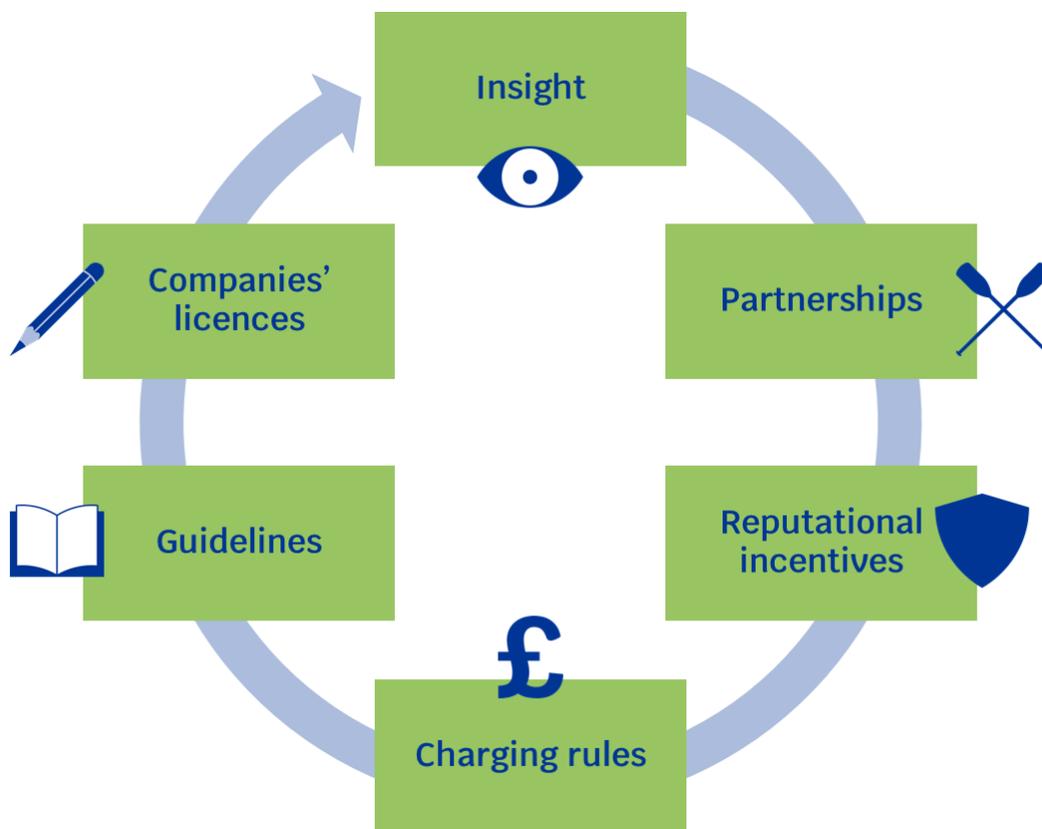
	Through the Wales PR24 Forum, Welsh stakeholders will provide a key input into the phasing of the long-term outcomes. This will include strategic steers to the Welsh water companies on customer priorities across customer outcomes, service levels and environmental outcomes; and how these priorities should be balanced with customers' affordability.
<b>Customers' views</b>	Through our guidance for acceptability and affordability testing, we want to improve the quality and consistency of research approaches. Engagement with customers and wider stakeholders should provide information about views on the affordability of company plans and should focus on aspects of business plans where customer views can have a meaningful influence.
	We expect each company to hold two Your Water, Your Say sessions to provide opportunities for customers, their representatives and other community and environmental stakeholders to pose questions to the company about their concerns and priorities, in a public environment.
<b>Customers' diverse needs</b>	We expect companies to engage meaningfully with customers to understand their diverse needs and perspectives, including financial constraints, and reflected these needs in their plans. We expect companies to demonstrate that they have adopted the approach to acceptability and affordability research for PR24, which introduces standardisation.
<b>Current and future customers</b>	Each company will need to propose cost recovery rates (pay as you go (PAYG) and RCV run-off) consistent with the guidance we set out, in particular, having regard to balancing the recovery of costs between different generations of customers and affordability for customers.
<b>Quality and Ambition Assessment</b>	We will be testing companies' business plans through conducting a Quality and Ambition Assessment. Affordability is one of the areas where, if a company demonstrates ambition, it could get rewards, depending on whether the plan overall represents value for money. This includes how companies are supporting customers who are struggling to pay.
<b>C-MeX</b>	Our customer measure of experience (C-MeX) is designed to incentivise water companies to provide an excellent customer experience for residential customers, including for customers struggling to pay. C-MeX comprises surveys that ask customers how satisfied they are with the service provided and how likely they would be to recommend the water company to family or friends. C-MeX scores are used to calculate financial incentives.
<b>Innovation and efficiency</b>	In setting expenditure allowances, we expect to make greater use of benchmarking, incentivising all companies to deliver expenditure efficiently. We expect companies to deliver a step change in efficiency so that they can deliver the improvements required by governments and regulators in an affordable way. Our expectations in this area will be stretching but achievable.
	We retain cost sharing at PR24 which allows companies to keep a share of any underspend relative to their ex-ante expenditure allowances. This incentivises companies to spend efficiently during 2025-30.
	We set stretching but achievable performance commitment levels from efficient expenditure allowances. Companies will receive payments for going beyond these performance commitment levels where the benefits of doing so outweigh the costs to customers, thereby delivering value for money.
	We expect companies to deliver innovation and cost efficiency by making better use of markets, for Direct Procurement for Customers (DPC). This is where companies put major projects out to competitive tender for delivery by

	third parties, with the aim of reducing capital, operational and financing costs. These cost savings will be passed directly to customers through a reduction in bills
	The Innovation Fund encourages companies to find new ways to deliver and share learning, thereby delivering greater value for money.

## 5. Our wider toolkit to support affordability

We are aware of the considerable challenges facing households, including customers in vulnerable circumstances, as cost of living pressures continue. In addition to PR24, we use our wider toolkit outside of PR24 to support customer affordability, particularly for customers struggling to pay their bills (see Figure 5.1). This includes our charging rules and guidelines on debt management, and our wider work on affordability with CCW and others. We set out more details about each area under Figure 5.1.

**Figure 5.1 Our other regulatory tools to support affordability and drive better outcomes for customer service and support**



### 5.1 Insight

Understanding customers through research and engagement is important for generating insights on peoples' needs and identifying areas of good and poor company practice. We use customer research – such as recent research on cost of living and customer experiences of sewer flooding – to better understand customers' experiences, and to test our own policies,

as well as to challenge companies about their performance.<sup>8</sup> We also collect insights from companies directly through annual reporting and one-off information requests which enable us to monitor company performance, including in relation to affordability metrics. This includes our recent Paying Fair information notice to collect data every quarter from all water companies on the levels of debt owed by household customers in England and Wales.<sup>9</sup> These insights help shape our policy priorities and focus areas, as well as allowing us to evaluate our effectiveness.

## 5.2 Partnerships

We work closely with CCW to deliver better outcomes for customers, for example by collaborating on customer research. CCW's remit includes:

- handling customer complaints about companies;
- the provision of advice and research; and
- engagement with water companies on their charges and social tariffs.

We engage with other customer organisations and charities to understand customer trends, as well as work with other regulators on common issues and learn from developments in other sectors.

## 5.3 Reputational incentives

Alongside our use of financial incentives, we play a role in enhancing reputational incentives, for example, by regularly collecting and publishing information on water company performance. Our approach is designed to increase the reputational benefits of companies delivering improvements in customer service and support. For example, in a joint letter with CCW, we asked companies to explain what they are doing support for customers through cost of living pressures.<sup>10</sup> We will report on companies' responses to our letter in early 2023. We also use reputational incentives through delivering campaigns. For instance, in Listen Care Share we provided insight into what water company customers have experienced throughout the Covid-19 pandemic. We published examples of water companies quickly adapting to the changing circumstances to support customers.

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<sup>8</sup> Ofwat, [Customer experiences of sewer flooding](#), May 2022.

<sup>9</sup> Ofwat, [Paying Fair request for information](#), November 2022.

<sup>10</sup> Ofwat, [Supporting customers through cost of living pressures](#), October 2022.

## 5.4 Charging rules

Water companies must comply with our charging rules when setting their charges. Our charging rules are based on principles and give companies ownership of their charges, as well as flexibility and ability to innovate. We have recently consulted on innovation in household charges to support affordability<sup>11</sup> and called on water companies to conduct charging trials that are accompanied by effective customer engagement and support. As part of this work, we continue to engage with water companies and stakeholders to support companies introducing charging innovations aimed at delivering better outcomes for customers.

We require companies to consult with CCW before finalising their charges each year, and to undertake additional scrutiny and reporting if they significantly increase their charges.

## 5.5 Guidelines

One of the areas we are taking action to protect consumers struggling to pay is in our work to strengthen our expectations of how water companies should treat their customers in financial difficulty. In May 2022 we published new guidelines for water companies to help household customers across England and Wales pay bills, get help and repay debts.<sup>12</sup> Our Paying Fair guidelines underline the importance of companies supporting customers in financial difficulties and other vulnerable circumstances. This includes new expectations underlining the importance of services being 'Inclusive by design' and considering how customers' ability to pay and vulnerability affect their service experience.

We have asked water companies to update and submit revised core customer information and compliance information to us to reflect our guidelines, and we expect to report on this in spring 2023.

## 5.6 Companies' licences

We are taking forward work to develop a new customer focused condition for water companies in their instruments of appointment ("licences"),<sup>13</sup> with the aim of delivering high standards of customer service and support to the full diversity of customer needs. This is likely to include provisions of appropriate support to customers struggling to pay. Licence conditions can help increase companies' customer focus and incentivise the very best

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<sup>11</sup> Ofwat, [Consultation on charging innovation to support affordability](#), September 2022.

<sup>12</sup> Ofwat, [Paying fair – guidelines for water companies in supporting residential customers pay their bill access help and repay debts](#), May 2022.

<sup>13</sup> For more details, see our web page: [Customer-focused licence condition](#).

service, while ensuring that we have the right mix of regulatory tools to effect change when service falls short.

Existing licence conditions contain some protections for customers, such as the requirement that companies have guidance for customers who have difficulty paying bills and that companies provide a leakage allowance to metered customers under specific circumstances.

During 2022 we have been working with CCW, water companies and others to co-create the new licence condition. We plan to consult on changes early in 2023-24 before we introduce them into companies' licences.

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

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

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