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Information notice

July 2023

IN 23/05 Further guidance on price control deliverables for PR24

Introduction

This document sets out additional guidance for water companies on our expectations regarding how they should propose price control deliverables at the 2024 price review (PR24), which covers the 2025-30 period. Price control deliverables will set out: a) the outcomes or outputs expected to be delivered from enhancement and related expenditure; b) the expected timing of delivery of these outcomes or outputs; and c) the payments to customers if these outcomes or outputs are not delivered on time.

Water companies receive enhancement expenditure allowances through the price review process to deliver permanent increases or step changes in the current level of service to a new 'base' level and/or the provision to new customers of the current service. Enhancement funding can be for environmental improvements required to meet new statutory obligations, improving service quality and resilience, and providing new solutions for water provision in drought conditions.

We are introducing price control deliverables in PR24 to set out the key outcomes or outputs from enhancement and related expenditure, so that stakeholders and customers know what to expect from the funding provided. Where these outcomes or outputs are not delivered, price control deliverables allow funding to be returned to customers. Companies should use price control deliverables where investment is material, and the delivery of benefits cannot be easily or directly linked, or the costs fully covered, by performance commitments and outcome delivery incentives.

This guidance supplements the guidance provided in our PR24 final methodology[1] and should therefore be read alongside it. This guidance follows the discussions and feedback received from companies and other stakeholders at a workshop held on 25 May 2023[2], and builds on

[1] Ofwat, PR24 final methodology – Appendix 9 Setting expenditure allowances, December 2022, section 5.4.4, p.118-122.
[2] See meeting slides and summary of discussion.

the learnings from setting deliverables for our green economic recovery[3] and Accelerated Infrastructure Delivery Project work[4]. We thank all stakeholders for their engagement.

Water companies should use this guidance, in conjunction with the guidance set out in PR24 final methodology, to develop proposals for price control deliverables for inclusion in their business plans. We will continue to refine our approach to price control deliverables through the draft and final determination process.

We set out an impact assessment of this guidance in Appendix 1 of this guidance.

This document is structured as follows:

1. Where we expect price control deliverables to apply;
2. Structure of price control deliverables;
3. Types of deliverables;
4. Price control deliverable payments; and
5. Other issues.

1. Where we expect price control deliverables to apply

In the PR24 final methodology we said that price control deliverables should be used to protect customers for material enhancement investments. We set out below what constitutes a material enhancement investment.

For the purposes of submitting price control deliverables in business plans, we expect water companies to define material investments as 1% of relevant total expenditure (totex). This materiality threshold is broadly in line with materiality thresholds we set out in PR24 final methodology[5]. For price control deliverables, relevant totex should be defined as:

- for water related enhancement investments, the company's 'water' wholesale totex (including base and enhancement expenditure on water resources and water network plus) in the 2025-30 period; and
- for wastewater and bioresources related enhancement investments, the company's 'wastewater' wholesale totex (including base and enhancement expenditure on wastewater network plus and bioresources) in the 2025-30 period.

[3] Ofwat, Green economic recovery: Final decisions, July 2021, Appendix A1, p.92-133. Appendix A1 sets out measuring delivery and reporting requirements for each approved scheme.
[4] Ofwat, Accelerated infrastructure delivery project – Appendix 2 price control deliverables, June 2023.
[5] For cost adjustment claims we set out a materiality threshold by price control. We set out a 1% threshold for water network+ claims; 1% for wastewater network+ claims; 6% threshold for water resources claims; 6% threshold for bioresources claims; 4% for residential retail claims; and 6% for business retail claims. See pages 31 and 32 of Appendix 9 of PR24 final methodology.

The materiality threshold outlined above should be applied to the totex of each enhancement line grouping set out in Appendix 3 of this guidance. Each cost grouping captures the enhancement cost categories which address similar problems and share benefits or deliverables. For example, both supply-side improvements to the supply and demand balance and internal interconnectors seek to address current and future deficits in the supply and demand balance. These categories of spend also share the same benefit which is to deliver additional water available for use (WAFU) to a water resource zone.

Where the enhancement investment does not meet the materiality threshold, companies should propose additional price control deliverables where there is likely to be no or limited oversight of project delivery from other regulators (such as the Environment Agency, Natural Resources Wales and Drinking Water Inspectorate).

Interaction with the outcomes framework and cost sharing mechanism

We want to avoid price control deliverables duplicating existing incentives in our regulatory framework where this is not required to protect customers or the environment. In our PR24 final methodology we said that price control deliverables should be used where the benefits of the investment are not linked to, or fully protected by, performance commitments and outcome delivery incentives.[6] We also said that price control deliverable payments should have regard to the impact of non-delivery under the cost sharing mechanism.

Outcome delivery incentives are the financial consequences to companies of underperformance or outperformance relative to their performance commitment levels. For PR24 we intend to adjust performance commitment levels to reflect the impact of enhancement expenditure. Consequently, if a company does not deliver an enhancement investment on time it can expect to incur outcome delivery incentives underperformance payments. This will help to incentivise water companies to deliver investments on time, and to make the required improvements. However not all enhancements will impact performance commitments and even if performance commitments are impacted, outcome delivery incentives may not cover the total value of the investment.

The cost sharing mechanism refers to the policy treatment of over- or underspend against efficient cost allowances we set for water companies at each price review. The cost sharing rate on underspend captures the share of underspend that the company gets to keep. The cost sharing rate on overspend captures the share of overspend that the company needs to bear. Consequently, if a company does not undertake an enhancement investment, a proportion of the expenditure saved will be returned to customers. This will therefore provide some protection to customers if an investment is not delivered or delayed.

[6] Ofwat, PR24 final methodology – Appendix 9 Setting expenditure allowances, December 2022, section 5.4.4.

We expect companies to explain how the combination of price control deliverables, cost sharing and outcome delivery incentive payments will more than cover the cost of the protected enhancement so that companies are worse off if they under-deliver or do not deliver the funded improvement.

In our PR24 final methodology we set the following cost sharing rates which vary by business plan category[7]:

- for 'Outstanding' and 'Standard' companies, the cost sharing rate is 50% on overspend and 50% on underspend;
- for 'Lacking ambition' companies, the cost sharing rate is 55% on overspend and 45% on underspend; and
- for 'Inadequate' companies, the cost sharing rate is 60% on overspend and 40% on underspend.

The combination of outcome delivery incentives and cost sharing can provide protection to customers on the investment. For example, for 'Outstanding' and 'Standard' companies, customers could be protected if outcome delivery incentives enable customers to receive at least 50% of the value of the investment. For 'Lacking ambition' and 'Inadequate' companies, the level of protection will vary depending on whether companies are underspending or overspending overall. If they are overspending overall, outcome delivery incentives can provide protection if they enable customers to receive 55% of the value of the investment for 'Lacking ambition' companies, and 60% for 'Inadequate' companies.

We expect companies to propose price control deliverables where outcome delivery incentives linked to a material enhancement investment would not allow customers to receive at least 60% of the average unit cost of the investment. This is to account for the potential higher cost sharing rate on overspend for 'Inadequate' companies. Once we complete our cost and quality and ambition assessments, we will consider whether the proposed price control deliverables are still needed to provide protection on the investment. In doing so we will consider the cost sharing rate that the company will be subject to, and the time period over which the company is expected to be held to delivering the funded improvement through performance commitment levels.

To support any claim that a price control deliverable is not required for the reason stated above, companies should set out in business plans their assumptions about the impact of non-delivery on performance in relation to performance commitments.

2. Structure of price control deliverable

[7] See Appendix 12 of PR24 final methodology for the different business plan categories which are dependent on our quality and ambition assessment (QAA).

Companies should provide the following minimum information for each of their proposed price control deliverables:

- **Description of price control deliverable** – companies should set out and define the outcome or output[8] to deliver as part of the scheme or group of schemes. For example, this could be water available for use in Ml/d for water supply-side improvements or number of meters for metering schemes. Companies should set out the amount of outcome or output to be delivered and by when (including the month and year of delivery). Where outputs or outcomes are delivered by year, these should be set out in a separate table. We expect to set a common definition of the outcome or output across the sector for same areas of investment (we set out our expectations for key areas of expenditure further below).
- **Measurement and reporting** –companies should explain how they will measure, track and report the outcomes or outputs identified as deliverable.
- **Conditions on allowance** – companies should set out the conditions under which the expenditure allowances will be made available. This should include the amount of outcome or output that company needs to deliver, the timings for delivery, and other conditions on the allowance such as sharing of learning.
- **Assurances** – this should set out the assurances that the company will provide to show that the conditions of the price control deliverable have been met (including where this requires inputs from other regulators). We expect companies to provide independent third-party assurance with a duty of care to Ofwat on whether the conditions of the price control deliverable have been met or not. The company should set out the date by which these assurances will be provided to Ofwat.
- **Price control deliverable payment rate** – companies should set out the proposed payment rate that will apply to each unit of output or outcome that is not delivered by the end of the control period. Companies should specify the rate that will apply to each unit of output or outcome identified as a deliverable. Companies should also specify time incentive rates where applicable (see Section 4 below).
- **Impact on performance in relation to performance commitments** - where relevant, company should set out the likely incremental impact of the identified deliverables on its performance in relation to performance commitments. This impact should be set out on a cumulative basis for each year of the 2025-30 and 2030-35 periods.

Appendix 2 sets out an example of what we expect a price control deliverable to look like.

3. Types of deliverables

We want price control deliverables to protect customers if companies do not deliver the improvements that customers have paid for. For price control deliverables to provide

[8] Outcomes are what customers and society actually care about, while outputs are what water companies need to deliver to achieve the outcome.

adequate protection, deliverables should be easy to measure, track and verify. Where appropriate, they should also allow some flexibility over how benefits are delivered.

In Appendix 9 of our PR24 final methodology[9] we stated that:

- where possible, price control deliverables should be set at an outcome rather than an output level. Where the outcomes cannot be easily observed or measured, companies should set price control deliverables at an output level (eg water supplied, additional storage capacity). Output-based price control deliverables may also be appropriate where it would be disproportionate to track multiple outcomes where there is no obvious alternative to the proposed solution (eg a price control deliverable on number of meters to be installed can be used to track the delivery of a company's metering programme).
- Companies should set price control deliverables at the highest level possible to retain flexibility over the benefits to deliver using the most efficient solutions. This will also help to minimise the number of price control deliverables required. Price control deliverables at a scheme level may still be required to track the delivery of major schemes.

We expect companies to balance the flexibility to deliver the funded outcomes across several schemes with providing adequate protection to customers. Where unit costs vary significantly across schemes, aggregating deliverables up across schemes could reduce the protection that customers receive on the high-cost schemes. For example, if companies fail to deliver the higher-cost schemes, customers may only receive compensation at a rate equivalent to the average cost across all schemes, and so would not receive the full funding provided for the higher-cost schemes. Where unit costs and/or unit benefits vary significantly across schemes, we expect companies to set out scheme level deliverables within the same price control deliverable. This will enable customers to be protected for the funding they provide.

Once we have completed our cost assessment at draft determinations, we may decide to aggregate deliverables across schemes based on the cost drivers we have used in setting expenditure allowances. Therefore, while we are requesting companies to provide granular scheme deliverables at this stage, this does not necessarily mean that final price control deliverables will be set at this level of granularity.

Below we set out our expectations for key areas of expenditure on:

- the type and level of aggregation of deliverable; and
- additional information required to help us form a view about the type and level of aggregation of deliverable.

[9] Ofwat, PR24 final methodology – Appendix 9 Setting expenditure allowances, December 2022, section 5.4.4, p.118-119.

Guidance on deliverables for key areas of expenditure

Supply-side improvements and internal interconnectors

For supply side improvements and internal interconnectors, we expect companies to identify water available for use (WAFU), specified in Ml/d, as the deliverable. This deliverable should be aggregated across supply-side improvements to the supply and demand balance and internal interconnectors where appropriate. Companies should set out this deliverable by water resource zone.

Leakage

Where investment is material and the leakage outcome delivery incentive rate does not provide adequate protection to customers, we expect companies to identify leakage reduction benefits specified in Ml/d as the deliverable.

Where companies are proposing material investment in mains renewals to reduce leakage and companies are claiming a higher unit cost allowance compared to alternative solutions, we expect companies to identify length of mains renewals (as well as the impact of this on leakage reduction) as the deliverable. This is to protect customers against non-delivery of higher-cost solutions where these are best value. Companies should also identify the assumed levels of renewals in base allowances.

Metering

We expect companies to identify number of meters as the deliverable. Companies should split this deliverable by type of work (new installation or upgrade) and technology (basic, AMR, AMI). We will consider whether to aggregate deliverables across meter types and technology in the determination process. This will depend on the extent to which these factors affect costs.

Nutrients

We are considering using population equivalent, initial permit level and final permit level as possible deliverables as these are all likely to be relevant drivers of cost. We will use the information in business plan table CWW19 (on phosphorus and total nitrogen removal schemes) to form a view about the type and level of aggregation of the deliverable. We will consider whether some form of aggregation of population equivalent across schemes by initial and/or final permit level is appropriate as part of the determination process.

For nutrient neutrality schemes in designated catchments the permit level will be at the Technically Achievable Limit (TAL) of 0.25mg/l total phosphorus and/or 10mg/l total nitrogen. We expect solutions to be similar in sites which have similar nutrient permits under other legislative drivers. However, we recognise that nutrient neutrality schemes are site specific and therefore cannot be swapped.

Storm overflows

We do not have a firm view about the type and level of aggregation of the deliverable for storm overflow investments. We are considering equivalent storage (in m^3), number of sites and number of modelled spills reduced as possible deliverables.

To inform our view companies should provide in business plans the information requested in Appendix 3 of this guidance. This includes the following information for each WINEP/NEP scheme or action:

- WINEP/NEP scheme name and action ID;
- Reference to enhancement line in business plan table CWW3;
- Total capex, opex and totex;
- equivalent storage (in m^3); and
- modelled spill reduction.

4. Price control deliverable payments

In Appendix 9 of our PR24 final methodology[10] we said that:

- Price control deliverables should set out the associated under delivery payments;
- Customers should not lose out if improvements are not delivered. If companies fail to deliver improvements then the price control deliverable payments, together with any related outcome delivery incentive underperformance payments and cost sharing arrangements, should return to customers more than the allowed cost of the enhancement, and should reflect any foregone benefits; and
- Price control deliverables should be spread across 2025-30 to reflect expected improvements within the 2025-30 period as well as at the end of the period.

We set out further guidance on price control deliverable payments below.

Non-delivery and partial delivery

Price control deliverables will set out how much customers will receive where companies fail to deliver all or some of the funded outcomes or outputs by the end of the control period.

[10] Ofwat, PR24 final methodology – Appendix 9 Setting expenditure allowances, December 2022, section 5.4.4, p.120-121.

Where companies fail to deliver the funded outcomes or outputs, companies should return the funding to customers through price control deliverable payments. The calculation of any funding returned to customers should take into account the initial profile of spend and the time value of money, so that companies are not better off by underdelivering the funded outcomes or outputs than by returning the funding to customers.

Although companies may fail to deliver all or some of the funded outcomes or outputs by the end of the control period, they could still be on track to deliver them early in the following control period. Where this happens, companies should provide sufficient and convincing evidence of why it is in the customers' interests not to apply the price control deliverable payment for non-delivery. This should include evidence on the amount of investment already incurred, the extent of the delay and the reasons for the delay. Companies should also provide evidence and assurance on the updated target delivery dates. Any payment adjustments will consider differences in cost sharing rates between the two periods and whether there is any financial benefit to the company from the delay. This is in addition to any applicable outcome delivery incentive payments and time incentive payments (see below).

Interaction with outcome delivery incentives

if companies do not deliver an enhancement investment on time they can expect to incur outcome delivery incentive underperformance payments.

In general, we do not expect outcome delivery incentive payments to be netted off from price control deliverable payments. In line with our PR24 final methodology[11], this will enable customers to receive more than the costs of delivering the improvement so that companies are not better off by under-delivering than by delivering the funded improvement.

We are conscious that the combination of outcome delivery incentive payments and price control deliverable payments may expose companies to risks from non or partial delivery. We will therefore consider the extent to which we will net off outcome delivery incentive payments from price control deliverable payments once we see business plans. This will allow us to assess the uncertainty around the level of efficient costs and the potential impact of non- or under-delivery on outcome delivery incentive payments. Companies can submit evidence in business plans on the areas of expenditure where they consider that net-offs or other adjustments should be applied. We will consider the appropriate arrangements through our determinations process.

Late delivery

[11] Ofwat, PR24 final methodology – Appendix 9 Setting expenditure allowances, December 2022, section 5.4.4, p.121.

We expect the combination of price control deliverable and outcome delivery incentive payments to provide companies with strong incentives to deliver on time. Where the impact of under delivery on outcome delivery incentive payments is material relative to the value of the investment, we expect outcome delivery incentives to encourage timely delivery.

Outcome delivery incentives however may not always be material relative to the value of the investment. This may happen, for example, where outcome delivery incentives fail to capture the full range of benefits delivered by an enhancement investment.

Where the impact of under delivery on outcome delivery incentives is not material enough, we expect companies to propose how price control deliverable payments are going to encourage timely delivery. This could be, for example, through the use of a time incentive payment per month/year per unit of output or outcome that is not delivered on time.

Time delivery incentives should reflect the benefits forgone to customers which are not already captured by outcome delivery incentives as a minimum. These incentives should be in addition to the time value of money adjustments applied through the totex reconciliation models. We will consider the extent to which incentives for early delivery will be required as part of the determinations process.

To inform where we would expect companies to propose additional time incentives, we have looked at the time incentives used in PR14 and PR19 as well as those used by other regulators. The value of these incentives suggests a typical range of annualised forgone benefits as percentage of forecast totex of 2% to 15%, with the minimum rates ranging between 2% and 5% across the sources we have analysed. We have taken the mid-point of the latter range to inform where we would expect companies to propose additional incentives. Therefore, for the purposes of company business plan proposals, as a minimum we expect companies to propose additional time incentives where outcome delivery incentive rates do not provide annualised protection to customers for material enhancement investments equivalent to at least 3.5% of the forecast total expenditure. We will consider the appropriate level and application of time incentive payments through the determination process and whether any caps might be required. Companies can provide evidence on appropriate level and application of incentives and caps as part of business plans.

Interaction with cost sharing

We will adjust price control deliverable payment rates to account for cost sharing in draft and final determinations. Therefore, companies should not reflect cost sharing in their proposed price control deliverable payment rates in business plans. Proposed price control deliverable payment rates should reflect the full average unit cost across the protected enhancement.

Companies should clearly set out in business plans how price control deliverable payment rates have been calculated, including any cost assumptions used to inform the level of these rates.

5. Other issues

Profiling

We want companies to make sure that they can deliver their proposed PR24 programmes. We expect deliverables to reflect the profile of spend and to be spread across the control period. Where deliverables are focused at the end of the period, companies should propose interim milestones.

End of period reconciliation

Although price control deliverables will set out the profile of delivery across the control period they will be reconciled at the end of the control period, alongside our totex reconciliation.

We will monitor company progress against the delivery profile set out in price control deliverables throughout the PR24 period.

In period changes

Price control deliverables should encourage delivery of the funded improvements, enabling customers to receive the benefits they have paid for. If the scope of the improvements reduces within the period, customers would not receive the full benefits they have paid for. Therefore we do not expect price control deliverables to change in period. This means that we also do not expect companies to propose to link price control deliverables to permits or notices which might be subject to in period changes. Companies should be able to manage any delivery risks around unexpected events over the five-year control period. This is consistent with our approach to performance commitment levels.

We do not propose to use price control deliverables as an uncertainty mechanism to fund statutory interventions that are uncertain at the time of our final determinations. Price control deliverables are intended to be used as a tool to encourage timely delivery of the funded enhancements. We do not intend to use price control deliverables as an additional mechanism to fund enhancement investments.

Appendix 1: Impact assessment

We set out our approach to price control deliverables in the PR24 final methodology.[12] We are introducing price control deliverables in PR24 to set out the key outcomes or outputs of enhancement expenditure, so that stakeholders and customers know what to expect from the funding provided. Where these outcomes or outputs are not delivered, price control deliverables allow funding to be returned to customers.

While we will confirm our approach to price control deliverables in the draft and final determination process, our further guidance provides clarity on the following three main issues to assist companies in submitting their business plans:

- Scope of price control deliverables – the guidance specifies where we expect price control deliverables to apply and how overlapping incentives such as cost sharing and outcome delivery incentives should be taken into account when determining whether a price control deliverable is needed.
- Granularity of deliverables – the guidance sets out the further information that companies need to provide in business plans to help us form a view about the type and level of aggregation of deliverables.
- Size of the incentive – the guidance sets out that we expect outcome delivery incentives to be additional to price control deliverable payments so that companies have strong incentives to deliver the funded enhancements. We will consider the extent of net offs between price control deliverable payments and outcome delivery incentive payments through the determination process.

Our assessment of these changes suggests the following impacts:

- **Impact on customers.** Price control deliverables will encourage companies to deliver the PR24 enhancement programme on time. Where companies fail to deliver these enhancements, price control deliverables will return the funding to customers. We are targeting regulation where is most needed. The materiality thresholds that we have set out in our further guidance mean that price control deliverables are likely to cover 60% to 80% of the enhancement investment programme across the sector. The scale of the enhancement investment at PR24 could be two to three times greater than the enhancement investment allowed at PR19. This means that price control deliverables will provide protection to customers over a significant amount of investment, making sure that customers receive the benefits they have paid for.
- **Impact on Other Stakeholders.** Price control deliverables will also benefit other stakeholders who may benefit from the funded enhancements. We expect many of the enhancement investments at PR24 to deliver wider environmental and social benefits. For

[12] See page 90 of PR24 final methodology and Section 5.4.4, pages 118–122, of Appendix 9 of PR24 final methodology.

example, companies may build sustainable urban drainage systems or SUDS which will not only increase storage capacity to address storm overflows but will also bring amenity, biodiversity and carbon saving benefits to customers and society. Price control deliverables can be used to strengthen the incentives of companies to deliver these benefits.

- **Impact on companies.** The combination of outcome delivery incentive payments and price control deliverables may expose companies to risks from non or partial delivery. We expect companies to be able to deliver the outcomes and outputs set out in their business plan. We will consider the appropriate arrangements for managing risk though our determinations process as part of our considerations on the overall balance of risk and return.
- **Practicality and implementation.** Price control deliverables will add administrative burden on companies and Ofwat, but no more than it is needed to achieve the objectives of this policy. Companies will have to track and report on their performance in relation to their price control deliverables. We expect companies to be already doing this for enhancement expenditure as part of good practice. Ofwat will have to monitor and work out the payments that will need to be made at the end of the control period. We believe that the added administrative burden is likely to be outweighed significantly by the benefits that price control deliverables will bring in terms of strengthening the incentives of companies to deliver on time of what is likely to be a sizable investment.

Appendix 2: Example of PCD – Supply-side improvements to supply and demand balance

Example is purely illustrative only.

Scheme delivery expectations	
Description	Supply-side improvements and internal interconnectors to deliver water to meet the supply-demand balance. Company should deliver the water available for use (WAFU) benefits to the supply-demand balance of the relevant water resource zone (WRZ) in line with the profile in the final WRMP24 and funded at PR24.
Output measurement and reporting	Delivery of WAFU will be reported and monitored through the existing APR process and be consistent with WRMP annual review process.
Conditions on scheme	Company should deliver the outcome of the WRMP24 (ie level of resilience) for 2025-30 as funded by PR24. This outcome is set out in the table below.
Assurance	Independent third-party assessment and assurance of completed milestones and forecast of likely outturn position at 31 March 2030.

Forecast deliverables

Deliverable	Unit	2025-26	2026-27	2027-28	2028-29	2029-30	2030-31	2031-32	2032-33	2033-34	2034-35
Delivery of WAFU to meet SDB in WRZ 1 (cum.)	Ml/d	0.00	0.00	0.00	15.00	35.00	50.00	65.00	75.00	80.00	85.00
Delivery of WAFU to meet SDB in WRZ 2 (cum.)	Ml/d	0.00	0.00	0.00	5.00	15.00	20.00	25.00	25.00	25.00	25.00