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Ofwat PR19 Final Methodology

Ofwat toughens its resolve

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Introduction

Ofwat has published its final methodology for the next water industry price review (PR19). The methodology provides even greater clarity of what Ofwat expects from the industry, and companies can now use it to fine tune their business plans.

The regulator continues to raise the bar for the quality of the business plans it expects the companies to produce.

Ofwat has structured its methodology around four key themes for PR19: customer service, affordable bills, long term resilience and innovation. These themes underpin the methodology, along with the nine (or ten[1]) test areas against which Ofwat will assess companies' plans.

We consider that many companies will find PR19 to be a substantially more challenging price control process. Indeed, the regulator has stated it is possible no company will achieve the new "exceptional" status (which replaces the "enhanced" category of business plan assessment used at PR14).

The structural complexity of the PR14 process will be added to in PR19. In addition to the new methods and price controls already in place, Ofwat:

- expects the companies to "raise their game" on customer engagement;
- has extended the number of separate price controls;
- is promoting competition in the new water resources and bioresources markets;
- expects that companies will look for appropriate opportunities to procure services directly from third parties; and
- will use more complex techniques to benchmark the costs of the wholesale and retail businesses.

There are some welcome areas of standardisation and simplification. For example, there are more common performance commitments and a simplified approach to scenario analysis. Further, publication of an early view on allowed return of 2.4% (real, RPI, appointee), gives companies clarity to finalise their plans. While Ofwat strongly signalled a drop from PR14, and the industry has largely anticipated it in the current low interest rate environment, it is lowest regulatory allowed return we can recall.

The final determinations are very likely to leave the companies exposed to greater performance risk: tougher performance challenges, but greater rewards for outperformance. Ofwat is planning to remove the cap on the incentives for outperformance and underperformance. Although it has allowed for a glide path (of annual forecast upper quartile performance) on common Outcome Delivery Incentives (ODIs), performance targets will remain tough to achieve for most companies.

What does this mean for the water companies? There are many details to consider, but we think companies will now need to do four critical things to make the most of PR19:

1. **Focus on where to make a real difference.** Even the best companies will find it challenging to be exceptional across the board - just one area of material weakness can eliminate the chances of an "exceptional" or "fast-track" plan. The key to success will be identifying strengths to capitalise on, and weaknesses to overcome.
2. **Work hard to identify and emulate best practice outside the industry.** This could range from retailers using digital technology to engage with their customers, through to adopting project management techniques used by leading construction firms in complex infrastructure programmes.

[1] Board transparency and assurance on governance and financing may be separated out from test 9.

3. **Test the resilience of all aspects of the business** in an holistic way and engage with customers on the actions proposed to secure resilient supplies. This will add a new and important layer of complexity to the business planning processes.

4. **Be ready to implement plans with speed** - Ofwat expect high performance and efficient costs from the beginning of the next regulatory period - there will be no time for reflection after the Final Determinations. Companies should be ready to execute their plans before the end of 2018.

The remainder of this document provides:

- a summary of the main changes between the draft and final methodology. This table includes brief commentary on the impact of the changes.

- a high level full summary of each key area of the methodology along with brief commentary and analysis. The tables present Ofwat's overall approach to assessing business plans as well as the "test" areas, scoring each key issue on the extent to which Ofwat's approach might present a **challenge to companies** (for example, because the bar is materially higher, or the approach introduces greater risk or complexity).

While PR19 cannot be described as a revolution to the regulatory framework, there are important changes which require a new approach – companies cannot simply rely on the approach they adopted in PR14.

How PwC can help

PwC is a trusted adviser to the water industry and has been at the forefront of industry change, for example:

- advising Ofwat throughout the PR14 process as its Delivery Partner and contributing to Ofwat's emerging thinking on Water 2020 and PR19;
- being heavily involved in the Open Water Programme as advisors to the central programme, MOSL, companies and other stakeholders; and
- advising multiple water companies on the development and implementation of programmes to deliver on their PR14 commitments in retail and wholesale.

We act as regulatory and strategic advisors to companies and investors:

- providing advice on the development of business plans;
- acting as a source of independent views on PR19 plans as a "critical, informed friend";
- assisting with the fine tuning and interpretation of customer engagement plans;
- advising on cost-to-serve and on actions to deliver more efficient retail and wholesale operations; and
- advising on the development and implementation of Board assurance plans.

We also have wide experience and capability in portfolio and project management, including price review programmes.

Changes since the Draft Methodology

Test Area	Changes since Draft Methodology	Implications for companies
Test Area 1: Customer Engagement	Ofwat has clarified its expectations. This includes a methodology for engagement that allows environmental and social issues to be taken into account in companies' business plans, and clarification on companies' engagement with business retailers. Ofwat is engaging with CCGs more directly, and will meet with all CCG chairs every two months until July 2018 to provide ongoing support.	Although there are no material changes from the draft methodology, Ofwat has already set a high bar for the quality and depth of customer engagement. Customer testing should now focus on informing major decisions and the overall package of outcomes.
Test Area 2: Addressing vulnerability and affordability	Ofwat has revised the common metrics required on both affordability and vulnerability. These will be considered in the round, alongside other qualitative and quantitative information provided by companies. Ofwat has announced proposals to consider the use of a third party expert panels on vulnerability, and will undertake further development around the common metrics.	Companies will be required to report on a range of new measures from 2017/18.
Test Area 3: Delivering outcomes for customers	Ofwat has confirmed an expanded set of fourteen common performance commitments. This includes a revised commitment for "treatment works compliance". On leakage, performance commitments will now be assessed using a three year average. Ofwat has softened its position on the glide path for performance commitments - targets will now reflect the forecast upper quartile each year, rather than the 2024/25 upper quartile. Enhanced outperformance payments will now also be accompanied with corresponding penalties for underperformance. Ofwat has provided greater clarity on the high level design of C-Mex which includes a greater focus on complaints than implied in the draft methodology. The detailed design will be clear after Ofwat pilots C-Mex and D-Mex in 2018/19. The final design will be published in March 2020, taking account of learnings during the pilot stage.	While still challenging, the movement to forecast upper quartile assessments in each year is not as stretching as the proposal in the draft methodology of 2024/25 target throughout the 2020-25 price control period. The overall ODI package continues to present a significant challenge for companies on a 'catch up' performance trajectory in AMP6. **However, Ofwat has dropped the statement that it made at the Draft Methodology stage that an *"average company with average performance would expect to incur penalties on its ODI package, rather than rewards"*.** This will be a significant relief to poorer performing companies.

Test Area	*Changes since Draft Methodology*	*Implications for companies*
Test Area 4: Securing long-term resilience	Ofwat has amended its resilience principles to focus more explicitly on the need for resilience in the natural environment. It has outlined two forward-looking resilience common performance commitments (drought and flooding). Both relate to people or customers at risk during an extreme weather event. Ofwat has removed the extreme weather exception for the common performance commitment on sewer flooding. Ofwat has provided further detail on the evidence that companies may use to set out their case on resilience, including the range of options they should consider under Ofwat's second resilience test.	The removal of extreme weather exceptions from sewer flooding measures is likely to be challenging for companies as most will need substantial investment in their networks or drainage arrangements to reduce these flooding events. While Ofwat has provided some further guidance on the potential content of submissions, it has made clear in the 'Resilience in the Round' report that it wants companies to be more innovative.
Test Area 5: Targeted controls, markets and innovation	**Wholesale:** Ofwat has clarified the long term risk sharing arrangements for large investments in new water resources. Companies must set out how they propose to share risk for any such investments, guided by Ofwat principles. Proposals should be linked to long term outcomes and customer legitimacy; and companies should modify their approach where schemes enhance versus maintain resilience. Ofwat has refined the form of the bioresources control, introducing a revenue adjustment factor (which spreads the fixed costs only over actual volumes). This factor caters for circumstances where actual volumes vary from forecast volume. Ofwat has also introduced a forecasting accuracy incentive with penalties where actual revenue variance is > ±6% from forecast. Where companies can evidence (in the first two years of the price control) that improvements in measurement are responsible for variances, Ofwat will consider their case and may provide protection. **Retail:** The duration of the retail price controls has changed from three- to five years reflecting Ofwat's assessment that the cost and regulatory burden of a three year control outweighs the benefits of being able to draw on observations from the non-household retail market. An additional bespoke performance commitment has been proposed for "gap sites and void properties" to put greater onus on companies to tackle revenue under-recovery. This is designed to promote affordability and fairness of charges. It is expected to act as a financial incentive to recover revenue, and will be included in the initial assessment of company business plans. **DPC:** Ofwat also confirmed its expectations for the consideration of DPC for large scale enhancement projects, and that companies are responsible for choosing appropriate tender models.	**Wholesale:** The change to the form of the bioresources control adds clarity for companies on how volume variances will be managed, and a degree of protection. **Retail:** Ofwat set out in the draft methodology that companies should be focussed on demonstrating best practice debt management. Companies need to improve their management of void properties, which could be a factor underpinning the current wide variation in companies' performance. The requirement for a bespoke performance commitment in this area was highlighted recently at a working group, so companies will have been expecting this change. **DPC:** Ofwat's decision to attribute the choice of tender model to companies places the onus on them to develop and follow a robust model.

Test Area	Changes since Draft Methodology	Implications for companies
Test Area 6: Securing cost efficiency	**Rewarding outperformance:** Ofwat has proposed higher cost sharing rates for companies with more efficient business plans (than Ofwat's totex baseline), but lower cost sharing rates for less efficient business plans (compared to Ofwat's totex baseline). This is designed to incentivise submission of efficient plans. **Penalising underperformance:** cost sharing rates have been increased across the board, regardless of whether the plan is efficient or not (compared with Ofwat's totex baseline). Ofwat has markedly increased the cost sharing rates for underperformance for plans which are lower than Ofwat's totex baseline. These cost sharing rates are now flat at 50%, so companies can't reduce underperformance penalties by submitting a purposely low totex forecast.	Companies submitting efficient plans will benefit from higher cost sharing rates when they outperform, whilst those submitting inefficient plans will face a greater challenge.
	Measuring efficiency: Ofwat has confirmed it will use econometric modelling to benchmark companies' household retail costs and set efficient totex baselines in the retail controls, with a strong focus on forward-looking efficiency and other sector performance. Efficient levels of costs in other sectors will be taken into account when determining the efficiency level of cost for water companies. Ofwat has now set out the materiality thresholds in the Final Methodology with which it will allow companies to raise cost adjustment claims for unique or atypical material costs that they consider are not reflected in cost baselines. These are at a higher level than at PR14: Water network plus, 1%; Wastewater network plus, 1%; Water resources, 6%; Bioresources, 6%;Residential retail, 4%; and Business retail, 6%.	The introduction of forward-looking information on trends in efficiency will complicate companies' ability to forecast the outcomes of Ofwat's cost modelling. With higher cost adjustment thresholds than at PR14, companies will have fewer opportunities to make cost adjustment claims. As a result, companies will need to make their claims as robust as possible, supported by appropriately detailed evidence – this will include demonstrating that the most cost-effective option has been selected and that companies have considered the full range of options and assessed them in an objective way.
Test Area 7: Aligning risk and return	Ofwat increased the potential reward for companies that produce exceptional plans, indicating that these will receive an uplift of 0.2%-0.35% in RoRE terms (return on regulated equity). A new reward of 0.1% RoRE for fast track plans was also announced. The early view on WACC figure is markedly lower than the return used in PR14, dropping from 3.74% to 2.4% (real, RPI) at appointee level (with a 0.1% deduction for the wholesale WACC equivalent).	Increased rewards for fast-track and exceptional plans will be welcomed by companies who are striving to produce high quality submissions. While Ofwat strongly signalled a drop in the WACC, which the industry largely anticipated, the proposed WACC range is towards the lower end of expectations. Companies with embedded debt financing costs are likely to struggle in 2020-25.

Test Area	*Changes since Draft Methodology*	*Implications for companies*
Test Area 8: Accounting for past delivery	**Reconciliation:** Companies have the option to request up to 2 weeks' extension to submit their reconciliations after publication of their annual performance reports. Ofwat confirms that past performance should not prevent a company being categorised as "exceptional" or "fast-track". Ofwat has confirmed that C-MeX will run in 2019/20, replacing SIM, and that companies should use the contact survey part of C-MeX to evidence any SIM-related reputational commitments in their plans. Ofwat has left open exactly how it will apply SIM rewards and penalties, while confirming that financial incentives will depend on relative performance. **Initial assessment of plans:** Ofwat has adjusted the wording of the second test, which originally referred to how well the company has delivered its plan and engaged with customers. The test wording now specifies the level of past and forecast 2015-20 performance, and the measures in place to ensure successful delivery of a company's plan. Ofwat will reflect the level of stretch in previous business plans (although it will not differentiate between companies that were enhanced/ non-enhanced at PR14 in its assessment of plans).	Allowing companies more time to submit reconciliations is likely to be a welcome procedural change, as will Ofwat's confirmation that past performance would not prevent fast tracking or exceptional categorisation. The wording of the second test is now clearer. The Ofwat assessment of whether companies' PR14 plans were stretching will necessarily be qualitative, and risks regulatory judgements that may not reflect a company's real level of challenge.
Test Area 9: Securing confidence and assurance	Ofwat has placed increased emphasis on the need for companies to engage with customers on the way they are governed and financed.	The requirement to engage on governance and finance will be challenging for some companies, and will require an extension to customer engagement plans.

Key areas of the PR19 Methodology

Ofwat’s approach to assessing company business plans

Summary	*Challenge*	*PwC comment*
High quality, ambitious and innovative plans - Ofwat intends to assess company plans against three key characteristics: “high quality”, “ambition” and “innovation”. There are nine (possibly ten) areas which Ofwat considers will help deliver the key PR19 themes and which will form the basis of Ofwat’s test: 1. engaging customers; 2. addressing affordability and vulnerability; 3. delivering outcomes for customers; 4. securing long-term resilience; 5. targeted controls, markets and innovation; 6. securing cost efficiency; 7. aligning risk and return; 8. accounting for past delivery; 9. securing confidence and assurance; and 10. Board transparency and assurance on governance and financing (which may be separated out from test 9)	**High**	The characteristics Ofwat will assess are broader than at PR14 (which focused on “high quality” as the key characteristic). However, there are some consistent themes - for example a requirement for companies to be “cost efficient” remains critical. **On the whole, the assessment criteria look to be very challenging**. While Ofwat expects all companies to be able to produce a high quality plan, there are tricky aspects to some of the tests. For example, demonstrating an effective approach to customer engagement on resilience is not trivial, requiring companies to develop new (and more complex) approaches.

Summary	*Challenge*	*PwC comment*
Ofwat will categorise plans in one of four ways, which will have different financial, process and reputational consequences: • **Exceptional status** will be awarded to plans that are high-quality with significant ambition and innovation. • **Fast track status** will be given to plans that are high-quality and do not require material intervention to protect customer interests, but which are not ambitious and innovative enough to attain exceptional status. • **Slow track status** will be given to plans where material interventions are required in some areas to protect the interests of customers. • **Significant scrutiny status** will be given to plans which fall well short of the required quality and where major interventions are required to protect the interests of customers. If companies meet the requirements for "exceptional" they will receive a financial reward of +0.2 to +0.35% Return on Regulatory Equity (RORE) as well as the early draft determination which fast track companies will also receive. A welcome change for the Final Methodology is that fast track companies will receive a financial reward of +0.1% RORE.	**High**	Ofwat has confirmed that its assessment of business plan category will be "in the round" based on its assessment of plans against the nine test areas. PR19 expands the number of categories from three to four, introducing new hurdles to receive reputational, procedural and financial rewards. As for PR14, the 'bar' for achieving exceptional status is very high. For example, in some areas, it will not be enough for a company to demonstrate it is leading the water industry - it will need to demonstrate that it is stretching itself beyond industry norms (in some cases to the point of achieving upper quartile performance in other industries). **Ofwat has acknowledged how hard it will be for companies to meet its high standards.** The regulator has stated it is possible no company will achieve the new "exceptional" status. We note the addition of a potential downside for companies in the "significant scrutiny" category - Ofwat proposes cost sharing incentives which are biased downwards and will consider caps on ODI rewards (to be clarified in due course).
Simplified submissions - Ofwat intends to address some of the practical issues associated with the PR14 price review process - both for companies, and for itself. For example, it is introducing a secure online portal for companies to submit price control data (to replace the spreadsheet-based approach used in PR14). It is also limiting the page length for the main company submission - 200 pages for water only companies (WOCs) and 300 pages for water and sewerage companies (WASCs). The Executive Summary is limited to 5 pages. This excludes the supporting evidence, analysis and models companies have used in preparing their plans (which must also be submitted alongside the main company business plan narrative).	**Low**	The introduction of a secure data capture system, along with more streamlined submissions, should be welcomed by companies. This should help address some of the PR14 procedural issues, such as version control issues with data tables, and very lengthy and complex submission documents. Ofwat does not suggest a standard format/structure for business plan documents which could have made it even easier to compare business plan proposals across the industry. Instead, Ofwat is requiring companies to clearly signpost the areas of their plans that Ofwat should refer to when carrying out the tests involved in the initial assessment of business plans. This provides scope for companies to choose the best way to structure their main business plan narrative - for example, following Ofwat's key themes, objectives, the test areas, or their key customer priorities.

Summary	Challenge	PwC comment
Transparency - Companies are also required to make public the whole of their business plans and will need to provide very good reasons should they choose to redact any information from these plans.	Low	Transparency of business plans and other information is once again a priority for Ofwat. This was a particular source of contention for some companies at PR14, particularly regarding sensitive commercial or financeability information. Companies should consider (well in advance) the areas of their plans (or supporting evidence) they do not want in the public domain and should develop a compelling rationale for redacting this information.

Test Area 1: Engaging customers

Summary	*Challenge*	*PwC comment*
Customer engagement remains central to the assessment of company business plans - Ofwat has largely reiterated the approach for customer engagement set out in its *Customer Engagement Policy Statement and Expectations for PR19* document. The methodology highlights a principles-based approach to assessing the quality of customer engagement. The principles include the seven principles used at PR14, with seven new principles for PR19: • Owning the relationship with their customers; • Using robust/balanced/proportionate evidence, drawing on a wide range of techniques; • Engaging customers as an ongoing process; • Ensuring a two-way and transparent dialogue; • Understanding the needs/requirements of different customer groups; • Setting the context by using comparative information; and • Involving customers in service delivery.	**High**	Ofwat has very high expectations of customer engagement, referencing a "step change" from PR14 (although there is little, if any, change from the '*Customer Engagement Policy Statement and Expectations for PR19*' document released in May 2016). **Ofwat requires companies to draw on a wider range of sources and techniques - companies will need to develop their own approach to reconciling and reflecting these sources in their business plans.** Overall, the methodology underlines the need for significant, and ongoing customer engagement which will impact the timelines of the business planning process (and will now be challenging to meet if any company is still in the early stages of engaging with customers). We note that Ofwat is proposing to meet companies during 2018 to understand their approaches to customer engagement. These meetings are likely to influence the way that Ofwat applies its tests on customer engagement. For this reason companies will need to incorporate a degree of flexibility in their customer engagement programmes.
Customer Challenge Groups (CCGs) - The use of CCGs will remain a core component of the engagement strategy. CCGs will provide independent challenge to companies and independent assurance for Ofwat.	**Low**	As expected, the outputs of the CCGs will remain a core element of the business plan submission. Companies have some freedom to develop the scope and input of these. Since PR14, Ofwat has highlighted the success of the CCGs, although it has also prompted companies to provide more information to ensure CCGs can provide an effective scrutiny and challenge. Ofwat is engaging with CCGs more directly, and will meet with all CCG chairs every two months until July 2018 to provide ongoing support.

Summary	*Challenge*	*PwC comment*
Longer term issues - One of the new PR19 customer engagement principles is "engaging with customers on longer-term issues, including resilience". Ofwat has signalled that it expects companies to be *"creative in exploring the best ways to frame and interpret such engagement"*.	High	**Companies will need to evidence that engagement on resilience has been conducted effectively** and that it has taken customers' views into account. **We expect this to be complex to achieve.** There is no set approach for doing this and we expect a variety of methods across the industry.
Customer participation - One of the new PR19 customer engagement principles is "*involving customers in service delivery*". Water companies must demonstrate that they have begun to take into account four themes below: • **Futures** – customer participation to improve the current and future sustainability of water services; • **Action** – customer behaviour change, including saving water and helping to reduce sewer blockages; • **Community** – community ownership of water as an essential resource; and • **Experience** – increasing customer control of water in their home and of the service experience.	Medium	**Companies will need to evidence the role of customers in service delivery and the impact of this on their business plans.** Once again, there is no set approach for doing so and we expect a variety of methods across the industry. In the past, Ofwat has alluded to the use of behavioural economics as a technique to improve customer involvement, though the methodology clearly goes beyond this. This is a new area of focus compared with PR14 - some companies might find it challenging to demonstrate approaches in this area.
Engagement required by wholesalers - Wholesalers must engage with business customers on the wholesale services they provide to them, as well as business retailers.	Medium	Ofwat is encouraging wholesalers to retain the link with their (end) business customers. This is unchanged from PR14. However, **the requirement to engage with business retailers is new** and flows from the new retail market reforms.

Summary	Challenge	PwC comment
Customer data - Companies will need to evidence how they are making better use of customer data. This includes using insight and intelligence to do more for customers and improve efficiency, whilst protecting sensitive and confidential customer information.	Medium	There is an advance on PR14 . **Companies may be required to optimise data processes and security. Ofwat will further define its expectations in a customer data report to be released in 2018.** The timing of this report may have an impact on companies' business planning timelines.
Communications expectations - Companies must evidence how they have adopted the communications expectations set out below: • **Channels** – Use of channels that are two-way in nature, accessible, and relevant for customers; • **Messaging** – Evidence of the way that engagement has taken place; • **Governance** – A business-wide approach to communications, with Board-level oversight and feedback; • **Evaluation** - Evidence of the impact of customer engagement on the business and the plan; and • **Audiences** - Appropriate customer segmentation, engagement with a range of audiences, plans for ongoing engagement.	Medium	**Ofwat considers that good communications is the foundation of effective customer engagement**, and can drive important improvements in customer behaviour which can positively impact the cost base (e.g. reducing unnecessary calls). The Ofwat methodology does not elaborate on the details of how effective communications might be explicitly taken into account in the assessment of company plans, though it is reasonable to assume it would form part of Ofwat's view on the quality of customer engagement activities as a whole.

Test Area 2: Addressing vulnerability and affordability

Summary	Challenge	PwC comment
Three dimensions of affordability - Ofwat's assessment of business plans will consider affordability across three dimensions: overall affordability (value for money); affordability in the long term; and affordability for those struggling (or at risk of struggling) to pay. Ofwat has adopted a principles-based approach for its assessment of companies approaches, drawing on five themes: 1. customer engagement on affordability and bills; 2. customer support for proposals to address affordability; 3. the effectiveness of companies' plans in improving affordability; 4. the efficiency of companies' proposed measures; and 5. the accessibility of help/support for customers struggling to pay. Ofwat also requires companies to report against a number of common metrics relating to affordability which will be considered in the round alongside quantitative and qualitative evidence. Evidence from CCGs will form an important component of Ofwat's assessment.	Medium	Affordability is one of Ofwat's key themes for PR19. As for PR14, Ofwat is expecting companies to provide quantitative and qualitative data to demonstrate the affordability of their plans. However, **there is now a greater and more explicit emphasis on longer-term affordability and on affordability for different customer segments.** Ofwat's principles for addressing affordability recognise that affordability is impacted by all aspects of company business plans, especially cost efficiency and ODI outperformance payments or penalties (which clearly impact on the overall customer bill). **This places even greater pressure on companies to strike the right balance between achieving bill reductions versus the cost of improving performance and resilience.** In addition, Ofwat's approach places a sharper emphasis on understanding the needs of different customer groups, and on obtaining broad-ranging customer support for targeted support.
An explicit test for vulnerability for the first time in a price review. The final methodology now presents a clearer definition of vulnerability which was not made clear in the draft methodology. Ofwat's assessment of companies' approaches to vulnerability will include the following qualitative measures: 1. how well companies use data to understand and identify their customers in circumstances that make them vulnerable; 2. how well companies engage with other utilities and third parties to identify and support customers; and 3. how targeted, efficient and effective companies' approaches are. Companies are expected to have at least one bespoke performance commitment for addressing vulnerability	Medium	Ofwat's customer engagement tests will consider how well companies have engaged with customers in circumstances that make them vulnerable, and how well they have reflected the views of those customers in their plans. Ofwat is also expecting companies to adopt a more joined-up approach on vulnerability, including engaging with other utilities and third party organisations on vulnerability issues, to identify and provide flexible support to customers in situations that make them vulnerable. This will be challenging for companies to do given this is a very broad ranging topic requiring a multitude of different types of support packages. Understanding vulnerability in the region and identifying what should be addressed within the company vs by third party experts and set performance commitments will need to be finely balanced.

Summary	Challenge	PwC comment
Companies will be required to include at least one bespoke performance commitment for addressing vulnerability, after engaging with customers and considering the views of their CCG. In addition, companies will be required to report publicly against a series of common metrics relating to non-financial support. These will be considered in the round along with the qualitative and quantitative evidence provided by companies and their CCGs.	Medium	**Ofwat's proposals further reinforce the need for companies to have a coherent approach for segmenting their customers and differentiating the service and support they provide to different customer groups.** Ofwat has recognised that there is no "one size fits all" approach - there will be a range of approaches across the industry. **Ofwat is likely to look for examples of good practice and encourage all companies to consider and/or follow suit.**

Test Area 3: Delivering outcomes for customers

Summary	Challenge	PwC comment
More "common" performance commitments - Ofwat is expanding the scope of "common" performance commitments from six to fourteen: • Eight commitments relate to customers' day-to-day experience of performance, four relate to asset health, and two focus on forward-looking resilience. • Three commitments will be subject to a common (upper quartile) performance level target - water supply interruptions; internal sewer flooding; and pollution incidents. Ofwat has stated that it will remove the exclusion for extreme weather from the sewer flooding commitment. • On leakage, companies will be required to justify their proposals against options including a 15% reduction by 2025, or upper quartile performance (this is more stretching than PR14 targets which were set on the Sustainable Economic Level of Leakage, "SELL"). Companies will be expected to report on leakage on a consistent basis, using three-year averages. There are no default financial incentives for the two new (proposed) resilience metrics. For these, it will be up to companies to propose ODIs if appropriate and supported by customers.	High	**While the overall outcomes framework remains largely the same as PR14, there are significant changes to the details.** Further standardisation of performance commitments (via the fourteen "common" performance commitments) is a material change. Ofwat has recognised that this extensive standardisation will require some companies to make changes to how they collect performance data and that, in some cases, it will take some time to have robust data. Ofwat has drawn a clear distinction between common definitions and common performance levels. Only a small number of the common commitments will have a standard target based on the upper quartile performance level. **Companies will be required to meet the forecast upper quartile level of performance in each individual year.** This is a significantly more challenging approach than at PR14, which set benchmarks using historical data. It is, however, a softening from the draft methodology position where companies would have been required to meet the 2024/25 forecast upper quartile from the first year of the price control or face penalties. For the other commitments (which are not subject to upper quartile benchmarking), Ofwat is widening the approach it expects companies to take, moving away from (sole) reliance on cost benefit analysis to set the economically efficient level. Companies will likely adopt a range of approaches to setting performance levels, which Ofwat will evaluate in its assessment of business plans.
Bespoke commitments - Companies will be required to propose bespoke commitments in a number of prescribed areas - vulnerability, the environment, resilience, and the Abstraction Incentive Mechanism ("AIM"). Companies will also be required to demonstrate how their commitments cover each price control. Companies will have to provide strong evidence if they do not want to continue with any of their PR14 commitments, or if they do not want to apply a financial ODI to a given performance commitment.	Low	Ofwat's approach allows companies to innovate by setting bespoke performance commitments. However, Ofwat balances this against its desire for greater transparency and comparability. For example, companies must choose from a long list of asset health metrics with standard definitions, and avoid any aggregation of measures. Ofwat's approach to bespoke commitments is likely to be less challenging than for the common commitments, though we expect some companies will look to revise their existing commitments.

Summary	*Challenge*	*PwC comment*
Customer Measure of Experience (C-Mex) and Developer Measure of Experience (D-Mex) replace Service Incentive Mechanism (SIM) in household retail C-MeX will be based upon surveys of customers who have contacted their water company, but their issue may not have been resolved. C-MeX will also survey a random selection of customers, who may or may not have contacted their water company. It is still expected to be made up of two key elements, customer service and customer experience. The final methodology now includes a gate for complaints in order access the higher incentives payments. There is scope for higher rewards for the best performing companies - up to 12% of residential retail revenue. This is an increase from the current reward cap (6% of residential retail revenue) and will only be available if a company performs at or above the upper quartile based on the all-sector UK Customer Service Index (UKCSI) converted into a C-MeX equivalent. The annual financial incentives are capped at 2.4% of retail revenues. Ofwat has made some final decisions on the high-level features of C-MeX and D-MeX. However, it has not made final decisions on all aspects of the design of C-MeX and D-MeX. This is because the mechanisms will be piloted in 2018/19 and final design decisions made based on the results of that pilot. Through the pilot, Ofwat is intending to test the use of the Net Promoter Score (NPS). Final guidance is expected to be published after the results of the pilot can be observed. This is expected in March 2020.	Medium	Ofwat has previously consulted on options for replacing the SIM. The methodology puts forward a preferred option to be piloted before the start of AMP7. **Ofwat's proposed new incentive increases the potential rewards for excellent customer experience -** it effectively doubles the reward cap. However, these additional rewards will only be available if a company performs at or above a threshold based on out-of-sector customer service excellence. Water company performance on complaints will now act as a gate to accessing the higher financial performance payments available under C-Mex. This reintroduces a focus on complaints from the preferred position in the draft methodology but is also designed to reduce the disincentives for companies to undertake debt collection activity in case it leads to complaints. Aligned to the rest of Ofwat's methodology, there is an clear drive towards enhancing customer service and customer experience. Ofwat are working through the right balance of components in order to best incentivise companies to deliver great service to customers.

Summary	Challenge	PwC comment
Enhanced payments for frontier-shifting performance – Where performance on outcomes is expected to be exceptional, companies can propose higher incentive rates . The bar for attaining these larger rates is very high though. Specifically, Ofwat has set out that performance would have to be beyond the best level currently achieved by any company. Enhanced payments will only be allowed on common performance commitments. Where companies propose enhanced outperformance payments for the achievement of exceptional performance levels they must also propose a corresponding penalty for exceptional underperformance (for example at or below the level of the current lower quartile company), to deal with the issue that the companies may take unreasonable short-term risks to obtain these rewards.	Medium	Currently, most ODIs have caps and collars which limit the scope to earn large rewards for exceptionally strong performance. **The proposed approach would allow companies who deliver a "step-change" in performance to earn rewards at a scale that is currently unavailable. However, the bar is high, and we expect other aspects of ODI design are likely to have a larger impact on most companies.** In explaining this development, Ofwat acknowledges that it is moving away from its previous approach of calculating rewards and penalties based purely on customer valuations. It considers the previous approach does not take into account the wider benefits that all customers (nationwide) should obtain from shifts in performance that set a new benchmark for industry performance.
No ODI cap and other elements of ODI design – Ofwat has decided that the aggregate cap on ODI performance will be removed. This was set at ±2% Return on Regulatory Equity (RORE) at PR14, and Ofwat have now set an indicative range of ±1% to ±3% for PR19. However, at the individual ODI level, companies can propose caps (rewards) and collars (penalties) if supported by customer engagement. Companies will need to justify each ODI target 'bottom-up'. Ofwat may choose to cap downwards the potential rewards on bespoke commitments for companies in the Significant Scrutiny category on the grounds that it will have low trust in the data quality used in setting targets and performance. Ofwat has confirmed that it wants to see a far higher proportion of ODIs having financial, rather than purely reputational, consequences, and that the bulk of ODIs should be measured and settled on an in-period (rather than end-of-AMP) basis, with outperformance and underperformance payments credited against revenue rather than RCV.	High	**Ofwat's proposed approach builds on the PR14 approach, but with a significant increase in the amount of revenue at risk from outcomes performance.** Ofwat now expects RORE of between ±1% and ±3% linked to ODIs, though has noted that the upper end will only be achievable in extremely stretching circumstances, where companies deliver step changes in operational performance across all their performance commitments. The onus will be on companies to come forward with mechanisms for smoothing bill profiles in the event of there being significant one-off in-period rewards. Ofwat is setting very high expectations of the range and sources of customer engagement and valuation techniques to be used in setting and justifying performance commitments and ODIs, requiring a "step change" from PR14. Overall, the elements of the methodology on outcomes will now be challenging to meet if any company is not in the advanced stages of developing their proposals and engaging with customers/ stakeholders on their performance commitments and ODIs. (continues on next page...)

Summary	*Challenge*	*PwC comment*
		The overall ODI package continues to present a significant challenge for companies on a 'catch up' performance trajectory in AMP6. **However, Ofwat has dropped the statement that it made at the Draft Methodology stage that an *"average company with average performance would expect to incur penalties on its ODI package, rather than rewards".*** This will be a significant relief to poorer performing companies.

Test Area 4: Securing long-term resilience

Summary	Challenge	PwC Comment

Principles-based approach to securing resilience - Ofwat expects companies to consider resilience for AMP7 and in the longer term. Ofwat's expectations are based on seven principles. Companies should:
• Consider resilience in the round for the long-term. Ofwat considers that this includes a systematic and integrated understanding of service and system risk (short- medium- and long-term) across the entire business, including interdependencies. Ofwat defines resilience in the round to include:
  ○ corporate resilience: the ability of an organisation's governance, accountability and assurance processes to help avoid, cope with, and recover from, disruption, and to anticipate trends and variability in all aspects of risk to delivery of services;
  ○ operational resilience: an organisation's ability to avoid, cope with, and recover from, disruption to its finances; and
  ○ financial resilience: the ability of an organisation's infrastructure, and the skills to run that infrastructure, to avoid, cope with, and recover from, disruption.
• Work towards resilient ecosystems and biodiversity (for example including a natural capital approach to valuation);
• Be informed by their customers' expectations on levels of service;
• Consider a full set of mitigating actions and interventions, including co-operation and collaboration with other companies at a regional or even national level;
• Consider the best value solutions for customers in the long term;
• Link the outcomes they propose to their plans to manage resilience; and
• Provide Board assurance that plans have been informed by considerations on resilience.
	High	Ofwat considers that resilience has always been part of how it regulates the water sector. However, **PR19 substantially increases the focus on resilience** and for the first time it has become an explicit part of the price control process, and a separate test in the initial assessment of plans.
		The complexity of resilience as an issue, and the way in which it is incorporated into Ofwat's assessment process presents a significant challenge for companies. Resilience should, and will, on the one hand permeate the plans across all areas, in particular is supported by companies' proposed outcomes. On the other, companies will need to provide sufficient standalone evidence of their approach to resilience to address the Ofwat tests.
		Ofwat has made clear that the onus is on companies to develop a thorough understanding of resilience in the round, and the interdependencies between the different areas of resilience considered in forming a plan. In addition, companies will need to take a longer term view areas of their plan where they may not have done so previously. A long term view of corporate resilience may be especially difficult for companies, given that uncertainties are inevitable over future ownership and leadership of companies.
		Demonstrating that investment requirements relate to new issues (rather than current known issues that Ofwat expects to be fixed as part of business as usual operations) may also be challenging for companies.

Summary	Challenge	PwC Comment
Assessing and prioritising resilience risks - Ofwat's initial assessment of business plans will look specifically at companies' operational, financial and corporate resilience, measured against the seven principles described above. It will use two tests: • How well the company has assessed and prioritised the risks and engaged effectively with customers on the risks and consequences; and • How well the company has assessed the full range of mitigation options and selected the solutions that represent the best value for money over the long term and support from customers. Ofwat has said it will also consider: • The extent to which this appraisal is "*supported by sophisticated and global best practice techniques*"; • The extent of Board and third party assurance on resilience; • On its second resilience test, whether the company sets out a full range of resilience options which should include infrastructure, soft infrastructure, behaviours, response & recovery; and • On its second resilience test, whether companies have prioritised short term fixes over more sustainable long run solutions due to constraints (e.g. financing structure).	**High**	Ofwat has provided some broad suggestions for assessing and prioritising resilience risks, but has not set out a recommended approach. Leaving it up to companies to determine and apply "*global best practice techniques*" is likely to drive both innovation and a divergence in approaches. The sources of information set out in the final methodology are existing channels in the main (including existing business plan channels) and are mutually exclusive between corporate, financial and operational resilience. This means companies will need, individually, to come to a means of bringing resilience in the round together, including interdependencies between areas. **There is a significant risk that companies will fail to meet Ofwat's expectations.** This will also make Ofwat's assessment more challenging - there is a risk that new standards or requirements will emerge later in the price control process based on the best examples that emerge across the industry.

Test Area 5: Targeted controls, markets and innovation

Summary	*Challenge*	*PwC comment*
Wholesale controls		
Four wholesale controls - Ofwat has confirmed it will use four controls: water resources, network plus water activities, network plus wastewater activities and bioresources (with an additional control for Thames Water's Tideway Tunnel activities). The scope and form of network plus controls is broadly the same as the PR14 wholesale controls, with minor changes to the treatment of revenue from developers (which will be adjusted at the end of the period for changes in volume). The building block approach to determining allowed revenues which was used in PR14 will be retained. Existing RCV will be indexed 50% by the RPI and 50% by CPIH. New RCV additions will be indexed by CPIH.	Medium	This is an evolution from PR14 which opens up the potential for more targeted controls in water resources and bioresources activities. **The adoption of four controls will add complexity and granularity to data requirements.** Similarly, the minor changes on developer services revenue will increase transparency requirements for companies. The revised RCV indexation approach should be value neutral, but is likely to introduce inflation cashflow mismatches (e.g. RPI-linked contracts, RPI-index linked debt etc.).
Protection of water resources RCV until 31 March 2020 - Ofwat will use an "unfocused" RCV allocation approach (an approach that allocates pre-2020 RCV proportionately between network plus and water resources). An "unfocussed" allocation results in allocating less of the RCV to water resources, thus placing less of the RCV at risk. As a consequence of market opening, future investments in water resources could be underutilised. Efficient investment will be protected up to 31 March 2020.	Low	The water resources control is new for PR19. Water resources is a relatively small proportion of the value chain, but the protection of historic investment will nonetheless provide some comfort for both companies and investors.
Water resources risk-sharing and forecasting incentives - Ofwat will require water companies with significant investment in new water resources after 2020 to propose long term risk sharing arrangements for sharing market-wide utilisation risks with their customers for Ofwat to review.	Medium	**The water resource risk-sharing incentive may be complex to design and will expose companies to increased risk.** Companies will be familiar with incentives to improve the accuracy of their forecasting. The application of these incentives to water resources is a natural extension of PR14 policy.

Summary	Challenge	PwC comment
Water resources access pricing and 'bidding in' - Companies will submit a proposed access price by Water Resource Zone (WRZ) and demonstrate how this aligns with their own costs. Companies are required to produce an assessment framework (which they will use when bidding into Water Resources Management Plans). This is designed to build confidence with third parties that their bids will be fairly assessed. Ofwat have also outlined the introduction of a new mechanism to facilitate bilateral market entry from 2022. This includes a revenue adjustment to incumbents in the event of entry.	Low	This is a change from PR14. Ofwat states that detailed design of access prices will be addressed in its consultation on how to take forward wholesale markets (due early in 2018). There remains a residual risk that this consultation may not offer sufficiently detailed guidance on access prices, which places the onus and the risk on companies to present proposals that are compliant with competition law and tariff principles.
Water trading incentives - Ofwat will retain existing water trading incentives, which will need to be allocated between water network plus and water resources for trades in AMP7. This is designed to accommodate the development of the bilateral market. Ofwat's working assumption is that this market will open in 2022.	Low	These are only limited changes from PR14. The materiality of this issue will vary regionally depending on the capacity for water trading. As above, we note that Ofwat may not offer further guidance on cost allocation between controls before the business plans are submitted.
Protection of bioresources efficient investment until 2020 - Ofwat has confirmed that efficient investment will be protected to 31 March 2020. There will be an in-period reconciliation between collected revenue and allowed revenue. Ofwat has confirmed it will use a "focused" Regulatory Capital Value (RCV) allocation approach for bioresources. Companies have already proposed their RCV allocations for Ofwat to approve. Under the "focused" approach, the bio-resources RCV will be determined by the net Modern Equivalent Asset Value ("MEAV") of bio-resources assets. Efficient investments from 1 April 2020 will not receive the same regulatory protection – these will be exposed to the market for bioresources services.	Low	The bioresources control is new for PR19. By allocating the net MEAV for sludge assets to the bioresources control, the control should reflect economic pricing in contestable markets. The use of a "focused" RCV allocation approach will result in more RCV being allocated to bioresources, and thus more of the RCV is at risk, than would be the case under an "unfocused" or proportionate allocation approach. However, the protection of pre-2020 investment will provide some comfort for companies and investors.
Form of bioresources price control - Ofwat intend to use an average revenue control, using tonnes of dry solids (TDS) as the volume measure, with a revenue adjustment mechanism to provide protections from volume deviations from forecast. Ofwat has refined the form of the bioresources control, introducing a revenue adjustment factor (which spreads the fixed costs only over the actual volumes). This factor caters for circumstances where actual volumes vary from forecast volume.	Medium	**Adopting TDS volumes as a driver of revenue will have an impact on revenue actually recovered by companies.**

Summary	*Challenge*	*PwC comment*
Financial incentive for forecasting of TDS volumes – Ofwat is proposing that companies should face financial penalties if there are significant inaccuracies in sludge volume forecasts. Ofwat has introduced a forecasting accuracy incentive with penalties where actual revenue variance is > ±6% from forecast. The penalty rate is 10% of the revenue generated by the difference between actual and forecast sludge volumes. Where companies can evidence (in the first two years of the price control) that improvements in measurement are responsible for variances, Ofwat will consider their case and may provide revenue protection.	**Medium**	We note that the quality and volume of TDS may vary depending on factors such as the weather. **Companies will still be exposed to some forecasting errors. Given TDS volumes are not measured now** (for at least some companies)**, the scale of these errors may be material.**

Summary	*Challenge*	*PwC comment*
Direct procurement for customers		
Direct procurement for customers (DPC) - Companies will need to consider DPC for discrete, large-scale enhancements projects (or packages of works) with a whole-life cost of over £100m (on a totex basis). Companies will need to demonstrate that they have considered DPC and that they have adopted a robust DPC framework. Direct procurement will not apply to bioresources as Ofwat regards bioresource sites as contestable.	Medium	Direct procurement for customers is an addition since PR14. Thus far, companies have struggled to identity suitable projects and to make them attractive to a competitively appointed provider (CAP). We do not think DPC will feature in all water company business plans, so this is not a universal consideration for fast-tracking. However, **it is unlikely that those companies where DPC is relevant will obtain an exceptional of fast-track status without seriously engaging with Ofwat's DPC model.**
Types of DPC tender model - Ofwat considers there is scope to adopt the DPC tender model at different stages in the project lifecycle. Ofwat also considers that having a single tender model could realise benefits and increase investor interest. Ofwat has confirmed that the choice of tender model sits with companies at PR19.	Low	Ofwat's decision to attribute the choice of tender model to companies places the onus on them to develop and follow a robust model.
Managing perceived and actual conflicts of interest - Ofwat considers there would be potential or actual conflicts of interest if companies (or associated companies) were able to bid in their own tender process. Ofwat therefore proposes that existing appointees and associated companies should not be able to bid in their own processes.	Medium	Companies may be surprised that they stand to be excluded from their own procurement processes. **The requirement that appointees should not bid in their own tenders will increase the impact of DPC.**
Companies could bear the risk of failed procurement - Ofwat acknowledges that DPC tenders may not always be successful. When a DPC fails and the project is still required, the appointee will need to step in to provide the project. Companies will have a licence obligation to use all reasonable endeavours to ensure a successful DPC process and Ofwat could take enforcement action if it considered a company was not compliant. If the appointee could have prevented a procurement failure, they might be required to bear the procurement or tendering costs.	Medium	Ofwat's proposals reflect the regulator's strong commitment to direct procurement for customers. **Companies will need to work hard to make DPC a success if they are to avoid potential enforcement action and/or adverse financial consequences.**

Summary	Challenge	PwC comment
Retail controls		
Weighted average revenue controls - At PR14, Ofwat adopted a weighted average retail revenue control. This reflected the fact that there were differences in the cost to serve across customer types. For PR19, Ofwat will retain this approach so long as differences in retail costs remain.	Low	This approach is substantially the same as for PR14.
Five year retail price control - Ofwat consider that a five-year control is appropriate for the household price controls and the non-household price control in Wales. This has changed from the draft methodology which proposed a three price control for household retail. Ofwat has determined that the costs of regulatory burden outweigh the benefits of being able to further observe the benefits of competition in the Non Household retail market.	Low	This will be a welcome reversion for companies to align the household retail control to the other price controls
Non-household price control confirmed Wastewater business retail companies whose areas are wholly or mainly in Wales and water business retail companies that are wholly or mainly in Wales and customers use less than 50 Ml per annum will continue to be price controlled based on an average revenue control using a cost to serve and net margin approach. Water businesses whose customers use greater than 50 Ml per annum will have an average revenue control using the gross margin cap approach. Where retailers have exited the market former customers are protected by the retail exit code. Ofwat will review the price requirements in the retail exit code by the end of the current control period and determine whether they remain appropriate. Non exited companies will continue to be price controlled through an average revenue control based on cost to serve and net margin for customers using <5Ml and a gross margin cap for others.	Low	Ofwat has determined that non-household retail companies should continue to be price controlled to protect customers. Ofwat are determining if the provisions in the retail exit code are sufficient to continue to protect customers of exited companies. The approach is broadly aligned with PR14 and therefore, no major changes for companies.

Test Area 6: Securing cost efficiency

Summary	Challenge	PwC comment
Approach to benchmarking wholesale costs - To set totex baselines, Ofwat will use benchmarking analysis alongside a range of aggregated and granular models. Ofwat's models will draw on evidence from outside the sector, to inform the efficiency challenge for water companies. In the Final Methodology, Ofwat have added that they also intend to include a view of forward looking-looking efficiency in setting their cost baselines. Ofwat acknowledges the difficulties of benchmarking enhancement expenditure, which typically has unique characteristics. Thus, as for PR14, Ofwat will use a range of techniques to determine efficient enhancement costs.	**High**	During PR14, Ofwat relied heavily on a limited set of econometric benchmarking techniques. The way that Ofwat intends to assess costs in PR19 will take water regulation closer to the "rich picture" approach adopted by Ofgem. Ofgem's approach relies on the use of multiple techniques, the results of which are applied with judgement rather than using a mechanistic approach. This will be disadvantageous to those companies who have previously benefitted from the econometric approach (at both ends of the totex spectrum). Challenging Ofwat's views on efficient costs will involve technical analysis and complex arguments. **To engage in a meaningful way with the regulator, companies will be expected to draw on out-of-sector practices, as well as develop a view of forward-looking efficiency. This will require companies to establish new datasets and models that may be unfamiliar when compared with past price controls.**
Cost baselines - During PR14, and in previous price controls, Ofwat set cost baselines at the "upper quartile" of historical cost performance. Drawing on both forward-looking and out-of-sector data, suggests that Ofwat will have more discretion when setting cost baselines at PR19, which could result in a more stringent efficiency challenge. As for PR14, Ofwat will set efficiency baselines in a way that includes an element of catch-up and assumed, future productively increases. However, Ofwat will expect companies to be efficient from the start of the new regulatory period, i.e. there will be no glide path to the cost baselines.	**High**	If Ofwat has more discretion in the level it sets for efficient costs, **the burden will increase on companies to justify and present evidence of their own level of efficiency**, both on a forward-looking basis, and compared with other sectors. As a result of its forward-looking view of efficiency, **Ofwat will have more discretion when setting cost baselines at PR19, which could result in a more stringent efficiency challenge (e.g. beyond current or forecast upper quartile).** Furthermore, without a glide path, companies that are not efficient will need to work hard to make cost reductions from the very start of the price control period.

Summary	*Challenge*	*PwC comment*
Setting efficient expenditure for residential and business retail - Ofwat propose to use econometric benchmarking to assess cost efficiency in residential retail activities. In PR14, there was no adjustment of the retail controls to reflect inflation and Ofwat consider that this approach is still appropriate for PR19. As for wholesale costs, Ofwat will look for evidence on retail efficiency from other sectors as well as place a focus on forward-looking efficiency trends.	**High**	Moving to an econometric approach to set allowable retail costs is likely to change the "efficiency league table". It will also complicate the approach to cost adjustment claims (see below). **Companies will need to test their efficiency against a broader range of comparators, including non-water companies and take into account forward-looking efficiency.** Identifying suitable comparators will be challenging, and there is a risk that Ofwat focus on comparators which suggest the water sector is underperforming. **Ofwat have also alluded to placing more reliance on sectors that have adopted the totex and outperformance approach, implying comparisons with energy networks will be made.**
Evidence to support cost adjustment claims - Ofwat will assess cost adjustment claims against six tests: • **Need for adjustment** - is there evidence that the costs are not included in the modelled baseline? • **Robustness and efficiency** - is there evidence that the costs are efficient? • **Management control** - is there evidence that the company has taken all reasonable steps to control costs? • **Need for investment** - is there evidence that the investment is required and supported by customers and the relevant CCG? • **Best option** - does the option chosen represent the best value for customers? • **Customer protection** - will customers' interests be protected if the investment is cancelled, delayed or the scope is reduced?	**High**	The tests against which Ofwat will evaluate cost adjustment claims build on the tests which were applied during PR14. **While Ofwat is setting a high evidential bar**, it does not prescribe the evidence required in support of individual claims. This increases the risk that companies will not pass all of the six tests. **During PR14, companies typically found it challenging to assess whether costs were included in the modelled baseline and to demonstrate that the most cost effective option had been selected to deliver a given level of customer outcome.** Assessing whether the costs are already modelled can require complex econometric analysis. The assessment will be further complicated in PR19 by the way that Ofwat proposes to use a blend of top down and granular benchmarking techniques, that incorporate both out-of-sector and forward-looking data.

Summary	*Challenge*	*PwC comment*
Special Cost Factor Materiality Ofwat has now set out the materiality thresholds in the Final Methodology outside which it will allow companies to raise cost adjustment claims for unique or atypical material costs that they consider are not reflected in cost baselines. These are: • water network plus and wastewater network plus, 1%; • water resources and bioresources, 6%; • residential retail, 4%; and • business retail, 6%. *N.B. Figures are as a percentage of business plan (5-year) totex in the respective control.* Ofwat is also seeking to address a criticism of the PR14 cost adjustment process - that claims tended to be asymmetric– by proposing to consider whether offsetting adjustments are appropriate when a cost adjustment claim in made. Companies will be required to submit information on their expected claims early in the process (May 2018). This will allow Ofwat (and potentially other parties) to comment on and challenge companies' proposals. Companies will not be required to assure this early information and Ofwat states that the initial claims will not <u>automatically</u> have an impact on the way that Ofwat assesses the business plans.	**High**	With higher cost adjustment thresholds than at PR14, **companies will have fewer opportunities to make cost adjustment claims. As a result, companies will need to make their claims as robust as possible, supported by appropriately detailed evidence** – this will include demonstrating that the most cost-effective option has been selected and that companies have considered the full range of options, assessed in an objective way. **Ofwat will expect to see sophisticated analysis including the use of "real option valuation".** This will be complex to undertake. Companies should also note Ofwat's "symmetrical" approach to cost adjustments: Ofwat will consider whether offsetting adjustments would be appropriate for every adjustment made as a result of a company's claim. **Companies should understand the risks of off-setting adjustments that will need to be explained to Ofwat if they are to be avoided.** The **requirement to submit cost adjustment claims four months earlier than the business plan also creates challenges**, for example: • companies will need to advance this aspect of their business planning process; and • companies should expect to receive and need to respond to challenges from Ofwat (and potentially from third parties). Ofwat's statement that the early submission on cost claims does not need to be assured and will not automatically impact on the categorisation of business plans will be welcomed by companies.
Approach to funding unconfirmed environmental requirements - There is a mismatch between the five-year price review and the six-year river basin management planning cycles. This creates uncertainty around certain environmental programmes. Ofwat consulted on two approaches in the Draft Methodology and has decided to take forward an approach that links the allowance to an outcome and a unit cost mechanism.	**High**	Ofwat's preferred option will involve a detailed review of complex programmes and the application of regulatory judgement. The fact that evaluations are not mechanistic will allow companies greater opportunity to make robust arguments to influence Ofwat's thinking. **Nonetheless companies will face the risk that they will be unable to recover some of the costs of unconfirmed environmental programmes.**

Summary	*Challenge*	*PwC comment*
Cost sharing incentive - Ofwat is moving away from the "menu approach" for determining the cost sharing incentive. Instead, the cost sharing incentive will be determined in a mechanistic way by comparing company business plans to the outcome of Ofwat's cost assessment ("totex ratios"). For the Final Methodology, Ofwat has made some adjustments to the incentive rates available across the spectrum of totex ratios. Companies submitting efficient business plans will face more favourable totex sharing factors if they outperform their settlement; while companies submitting inefficient business plans will face lower sharing rates for outperformance: • The range of **sharing factors on outperformance** for exceptional, fast and slow track companies is 65% to 35%. • **For underperformance**, Ofwat has increased the sharing rates for both efficient and inefficient companies from the Draft Methodology. The range for exceptional, fast and slow track companies is 50% to 65%. • For companies whose plans are assessed to need **"significant scrutiny"**, Ofwat will set a fixed cost sharing rate for underperformance at 75% and for outperformance at 25%, irrespective of the company's totex ratio.	**Medium (for plans requiring "significant scrutiny")** **Low (for other plans)**	The PR14 menu approach was widely criticised for its complexity and for the limited extent to which the mechanism provided meaningful incentives for companies. The Competition & Markets Authority (CMA) underlined these criticisms during the appeal lodged by Bristol Water. Although the removal of the menu is a significant change, it will not heighten the challenges that companies face. **The sharper incentives in the Final Methodology, will put greater pressure on companies to match or beat Ofwat's totex baseline.** As noted above, this is likely to be more difficult given Ofwat's proposed changes in its approach to cost modelling. The imposition of asymmetric cost sharing for companies whose plans need "significant scrutiny" will create strong incentives for companies to reduce costs, and provide only limited upside when they are able to do so.
Business rates - In PR14, Ofwat treated business rates as a notified item. Ofwat do not propose that business rates should be a notified item in PR19. Ofwat expects companies to seek opportunities to minimise these costs.	**Medium**	Although companies have an influence on the level of business rates, some aspects of the business rates process are beyond company control. **Ofwat's position on business rates will increase the volatility of company earnings.**
Transition expenditure - Ofwat has decided to retain the Transition Programme, through which companies can advance expenditure between regulatory periods. However, Ofwat will only allow the transition programme in the network plus controls and, in exceptional circumstance only, the water resources control. Ofwat will not allow any transition expenditure in the bioresources or retail controls.	**Low**	Where companies propose transition expenditure, Ofwat will expect them to make ta case demonstrating that it is efficient to bring the investment forward, and explain why it was not part of its outcomes and long-term planning from PR14.

Summary	Challenge	PwC comment
Pension deficit repair payments – Ofwat will not change the pension deficit repair arrangements first set out in PR09 and continued in PR14. For a period of time, companies where able to share 50% of the cost of pension deficit repair payments with customers**.**	**Medium**	For many companies the arrangements for the sharing of pension deficit repair payments with customers will terminate during the 2020-25 control period. This means that companies will then be fully responsible for remaining pension deficits and future management of pension deficits. Pension deficits are still high, partly as a consequence of low yields used to discount future pensions liabilities. From this point any requirement to fund deficit repair payments will need to come from other pension efficiencies, business outperformance, or investor contributions.

Test Area 7: Aligning risk and return

Summary	*Challenge*	*PwC comment*
A significantly lower WACC for PR19 - Ofwat's early view on the WACC has reduced both the cost of debt and the cost of equity for PR19. This reduction has been supported by independent reports and a significant quantity of their own analysis. The early WACC figure is markedly lower than the return used in PR14, dropping from 3.74% to 2.4% (real, in relation to RPI) at appointee level (with a 0.1% deduction for the wholesale WACC equivalent).	**High**	Given the early stage of PR19, **there is some scope for the early view on WACC to be revised at draft and final determinations**. For example, a revision may occur where there is a marked change in financial market variables or economic outlook. In forming the WACC estimate **Ofwat has revised down notional gearing from 62.5% to 60%**. This lower level of notional gearing, all else equal, will help to alleviate pressure on notional credit ratios associated with a lower base allowed return.
RCV indexation - Ofwat has confirmed their approach to RCV price indexation set out in the draft methodology. Specifically, Ofwat have confirmed the use of CPIH as their preferred measure of inflation - this price index will apply to 50% of the existing RCV from the beginning of AMP7 (as well as to all new RCV additions from then onwards). The remaining part of the RCV from 2020 will continue to be indexed to RPI. Ofwat's precise approach to RCV price indexation beyond 2025 has not been fully detailed. To accommodate the use of different price indices, Ofwat has had to calculate two real WACCs for use with different price indices: (i) a real RPI WACC to apply to the RPI price indexed part of the wholesale RCV (2.3%), and (ii) a real CPI WACC to apply to the CPI price indexed part of the wholesale RCV (3.3%).	**Low**	The wedge between CPIH and RPI, estimated by Ofwat to be 100bps, is broadly in line with historical experience and OBR long-term forward looking views. The application of the higher real CPIH WACC to the CPI indexed component of the RCV means that cash returns are increased in the short-term relative to the previous approach of 100% RPI indexation. The corollary of this is that the CPIH indexed component of the RCV will grow at a slower rate-reducing longer-term cash returns relative to RPI indexation. This shift in indexation approach should be value neutral, as it is essentially a re-profiling of revenues. However, the short-term effect of higher cash returns should ease the pressure of lower overall economic returns on credit ratios.
Inflation – Ofwat's focus at PR19 is on setting a single nominal WACC which can then be deconstructed into real CPIH and real RPI terms. When converting from nominal to real terms figures in the final methodology Ofwat has applied CPIH of 2.0% and RPI of 3.0%.	**Medium**	The RPI assumption of 3.0% compares to 2.8% at PR14. This means there is a larger adjustment from a given nominal WACC to a lower real WACC, but expectation that future nominal price rises will be faster. RPI is currently at 3.9% (November 2017), but is likely to fall back by 2020 as the impact of sterling devaluation following the EU referendum result fades.

Summary	Challenge	PwC comment
The cost of equity - Ofwat's increased focused on "ex-ante" and "forward-looking" evidence for setting total market returns (TMR) has made the largest contribution to the decrease in the cost of equity. The real TMR (in RPI terms) at PR14 was 6.75%. In the early view for PR19, the equivalent figure is 5.44%. This is closely linked to the "lower for longer" interest rate environment that is expected to persist well into the 2020-25 period. Consistent with the draft methodology, Ofwat has placed less weight on long-run historical averages for setting equity returns. The early view also set out an equity beta of 0.77, which is lower than the 0.80 at PR14.	Medium	The real (RPI terms) TMR assumption selected lies towards the lower end of the range the CMA has applied in recent determinations / appeals (e.g. NIE in 2014, Bristol Water in 2015). However, the financial market information relied upon in those CMA decisions is now outdated, and there is uncertainty over how the CMA would view the shifts in financial market conditions that have occurred since PR14. As there is greater judgment in setting the cost of equity assumption, Ofwat is unlikely to make big movements, unless there is compelling contradictory evidence.
The cost of embedded debt - The fixed allowance for the embedded cost of debt has been set with reference to the median cost of debt across the sector (4.64% nominal) adjusted to real terms.	Medium	Ofwat's analysis on the cost of debt shows that there is high degree of dispersion in debt costs across the industry. The sector-wide median cost of debt used to set the allowance lies closer to the weighted average cost of debt for WaSCs and large WoCs (4.34%) than to the weighted average cost of debt for small WoCs (5.73%). The median approach to setting the cost of embedded debt means that companies with long-dated Artesian debt are more likely to have an actual cost of embedded debt greater than the allowance. For the WaSCs and large WoCs with the cheapest financing costs the allowance offers some scope for financial outperformance.
Cost of new debt indexation- Ofwat confirmed their approach of using long-term iBoxx bond indices to index the cost of new debt over the 2020-25 period. More detail was provided on the forecast assumption for the cost of new debt - which will be used to set initial bills - which is 0.38% (in real RPI terms). The early view also used a 15bps deduction from the iBoxx debt indices for sector outperformance. The weighting on the indexed cost of new debt within the WACC was also increased from PR14, rising from 25% to 30%.	Low	Cost of new debt indexation is a significant change in policy from PR14. It will reduce the potential for substantial financial outperformance and underperformance. Companies can still outperform by beating benchmarks and timing their issuance well, but will no longer be exposed to market movements in long-term interest rates. While the 15bps outperformance assumption may provide a small degree of challenge, the cost of embedded debt is the bigger challenge for companies. It varies significantly across the industry, and for some this will be a major drag on financial performance over the period 2020-25.

Summary	*Challenge*	*PwC comment*
Company specific adjustments - Ofwat has set a high bar for allowing company specific adjustments to the WACC. Specifically, Ofwat proposes a three stage approach when considering adjustments: a) Is there compelling evidence of customer support for the proposed adjustment? b) Is there compelling evidence that there are benefits that adequately compensate customers for the increased cost? c) Is there compelling evidence that the level of the requested adjustment is appropriate?	High	The emphasis on "compelling evidence" across this three stage test means that it will be challenging for companies to benefit from cost of debt or cost of equity adjustments.
Single wholesale WACC - The final methodology confirmed that there will be no differentiation in WACC across the wholesale price controls.	Low	There is no change in policy from PR14. Differential WACCs for different controls could have altered relative returns across the separate controls. This is a welcome, pragmatic step from Ofwat.
Financeability - Ofwat proposes to continue to use financeability ratios and that financeability issues will be resolved by using pay-as-you-go (PAYG)/RCV run-off, dividend constraints and equity injection levers. They also highlighted that they will intervene, where necessary, if the balance of evidence suggests that a company's overall PAYG or RCV run-off proposals are not appropriate or have been made to solve financeability constraints driven by a company's actual financial structure.	Medium	There are minimal changes in the policy position compared with PR14. Financeability assessment will still be carried out using a notional capital structure (Ofwat will assume 60% notional gearing). Board assurance is required for financeability at the notional capital structure and the appointee's actual capital structure.
Tax - Ofwat has confirmed that they continue to use an approach based on projected taxable profits for the appointed business. The taxation allowance continues to be set with reference to the notional gearing, or the actual gearing if higher. The calculation for taxable profit will use allowed revenues and expected efficient expenditure. Furthermore, Ofwat has confirmed that they will introduce a true up in respect of changes to corporation tax and capital allowance rates.	Low	The addition of reconciliations for changes in the corporate tax rate and change capital allowance rates moves the treatment of tax closer towards a pass-through cost to customers.

Test Area 8: Accounting for past delivery

Summary	*Challenge*	*PwC Comment*
Ofwat will assess two aspects of past delivery: 1. How well the company gave evidence of its proposed reconciliations for the period 2015-20; and 2. How well the company performed, and is forecast to perform over 2015-20 period and, taking into account this performance, how well it has put measures in place to ensure it maintains confidence it can successfully deliver its business plan. Ofwat will reflect the level of stretch in previous business plans (although it will not differentiate between companies that were enhanced/ non-enhanced at PR14 in its assessment of plans).	Medium	In addition to accurate and transparent evidence of performance, **Ofwat intends to use evidence of whether companies have met (or not) their AMP6 plans as an indicator of how achievable AMP7 plans might be.** This was not explicitly tested at PR14 and underlines Ofwat's desire for companies to be accountable to their customers. This is likely to require significant focus from companies with a track record of underperformance. Assessment of whether companies' PR14 plans were stretching will necessarily be qualitative, and risks regulatory judgements. Although Ofwat invites companies to submit evidence on lessons learned from 2015-20 and an assessment of level of stretch in 2020-25, it is unclear how Ofwat will differentiate in practice whether outperformance was due to management effort or lack of stretching targets.
Applying reconciliation adjustments - Ofwat has confirmed the approach set out in the Reconciliation Rulebook (published in 2015). Companies have the option to request up to 2 weeks' extension after publication of their annual performance reports to submit their reconciliations. Wholesale water RCV adjustments will be allocated across the water network plus and water resources controls, whereas wastewater RCV adjustments will be applied to the network plus price control only. For simplicity, the default assumption is that revenue adjustments will be applied to the network plus price controls. Companies have flexibility to propose the period over which adjustments are applied. Ofwat has not confirmed its exact approach on SIM rewards and penalties - it will do so after it has assessed relative performance in 2018/19.	Low	Ofwat has confirmed that companies should use the Reconciliation Rulebook to account for past delivery. At PR14, the rules for accounting for past delivery were not spelt out in detail. As a consequence, a number of companies struggled to meet Ofwat's aspirations in this area. Adoption of the Reconciliation Rulebook should reduce this challenge.

Test Area 9: Securing confidence and assurance

Summary	Challenge	PwC Comment
Board assurance of business planning - Companies and their Boards are responsible for submitting high-quality, ambitious and innovative business plans. These plans need to rest on good governance processes and be underpinned by robust assurance. Each (full) company Board must provide an assurance statement that demonstrates: • How it has challenged and satisfied itself that all the elements add up to **a plan that is high quality and deliverable**; • How it has challenged and satisfied itself that the overall strategy for data assurance and governance processes delivers **high-quality data**; • How it has challenged and satisfied itself that the business plan will enable the company to meet its **statutory obligations**, now and in the future; • How it has challenged and satisfied itself that its plan will deliver **operational, financial and corporate resilience** over the next control period and long term through its governance and assurance processes, taking account of its track record of performance; • How it has challenged and satisfied itself that it will enable its customers' trust and confidence through **high levels of transparency** and engagement with customers on **issues such as the company's corporate and financial structures**; and • How it has provided **ownership of the overall strategy and direction of the plan** in the long term. (continues on next page...)	Medium	The requirement for Boards to assure the PR19 business plans is in line with Ofwat's expectations for the previous price control review and with the position set out in the Draft Methodology. **Boards will need to be involved in multiple aspects of the plan and explain *how* they have undertaken assurance.** The requirement for Boards to provide **assurance on operational, financial and corporate resilience raises the bar** on the oversight that Boards will need to provide. We expect analysis and decisions in this area to be complex. The requirement for Boards to provide assurance of levels of **transparency**, especially in relation to **corporate and financial structures** will require particular care and may be challenging for some companies. **The explicit requirement that the Board should assure the way that delivery risks will be mitigated will extend Board oversight** of the planning process.

Summary	*Challenge*	*PwC Comment*
Boards are also expected to assure that: • The Plan has been **informed by customer engagement and CCG feedback**; • The plan is **affordable for all customers**, including in the long term. Also that appropriate assistance is included for **those struggling, or at risk of struggling, to pay;** • **Outcomes, performance commitments and ODIs reflect customer preferences** and are grounded in customer engagement, and the proposed approach to reporting on performance commitments is robust; • Expenditure forecasts are robust and **efficient**; • **The business is financeable** on the notional financial structure. Ofwat also expects Boards to provide assurance that the company is financeable based on its actual financial structure. Companies should set out clearly the steps taken to provide this assurance; and • The Board has identified the **risks to the delivery of the plan** and that it has in place **appropriate risk mitigation and management plans**. Whilst it is still up to companies and their Boards to determine how best to provide this assurance, Ofwat has said it will obtain confidence from the process that the Board followed in obtaining when undertaking assurance.		

Summary	*Challenge*	*PwC Comment*
Role of assurance in the initial assessment of business plans - "securing confidence and assurance" is one of the core elements of the initial assessment of company business plans. **Ofwat will assess the extent to which the company's full Board**: • Has provided comprehensive assurance to demonstrate: all the elements add up to a business plan that is **high quality, deliverable; and has challenged management** to ensure this is the case. • Has been able to demonstrate that its governance and assurance processes provide **operational, financial and corporate resilience**. Ofwat consider this will require companies' Boards to assure that companies' business plans have been informed by: ○ **a robust and systematic assessment** of the resilience of the company's systems and services; ○ **customer views** on managing resilience; and ○ **comprehensive and objective assessment of interventions** to manage resilience in customers' long-term interests. • Has provided comprehensive assurance to demonstrate that the business plan will **deliver and monitor its outcomes** and that the plan is consistent with relevant obligations. • Has provided assurance that the business plan will enable customers' trust and confidence through **high levels of transparency** and engagement with customers, on issues that matter to customers (which extends to their ability to understand both the c**ompany's corporate and financial structures** and how they relate to its long-term resilience). (continues on next page...)	**Medium**	Ofwat has made clear that the 2018 company monitoring framework assessment will be an input to the initial assessment of business plans. **By implication, companies that do not perform well in the 2018 assessment are less likely to secure fast track or exceptional status.** Companies will need to maintain a focus on monitoring at the same time as they are developing their business plans. Companies face a minor degree of uncertainty on the implications of this procedure, as the 2018 company monitoring framework assessment will be published with the initial assessment of plans in January 2019. Companies will need to keep good records to demonstrate how their Boards have taken ownership of the plan, and how they have challenged the assumptions made by company management.

Summary	Challenge	PwC Comment
Further, **Ofwat will assess**: • The extent to which the company has a **track record in producing high quality data** (taking into account the 2018 company monitoring framework assessment); and • **The quality of PR19 tables**, including cost allocation, information on corporate tax and associated assurance and commentary. Ofwat have confirmed that the **results from the 2018 company monitoring framework will be taken into account** as part of the initial assessment of plans. This assessment will be released at the same time as the initial assessment of plans.		
Direct Procurement assurance - Ofwat expect companies to provide appropriate assurances that they will be able to meet their obligations if they appoint competitive appointed providers. In the event that Direct Procurement for Customers results in a failed procurement process, Ofwat expects companies to analyse the reasons for the failure, potentially including independent assurance to assess the process.	Low	The requirement for assurance and an independent assessment in the event of a failed Direct Procurement process will only impact a few companies.
Other aspects of policy retained from PR14 - There are a number of other areas where Ofwat is looking to retain the policy position it adopted at PR14: • As for PR14, assurance will need to cover: customer engagement, outcomes and cost assessment. • Again, as for PR14, a business plan can only be of high quality where the data and information provided within the plan has been subject to good assurance processes to ensure it is consistent and accurate.	Low	These other aspects of assurance are in keeping with the position adopted by Ofwat at PR14.

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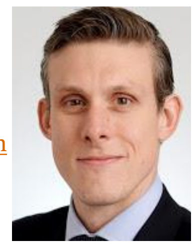

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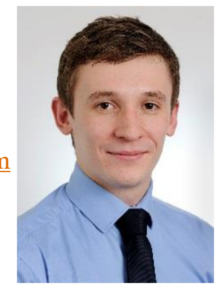

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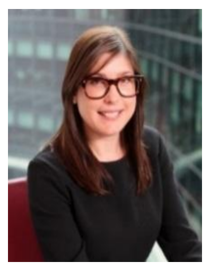

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