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Direction of travel for PR24

Ofwat has published its latest PR24 consultation paper.¹ This builds on its December paper outlining challenges for the sector and will be followed in summer 2022 by its full PR24 methodology.

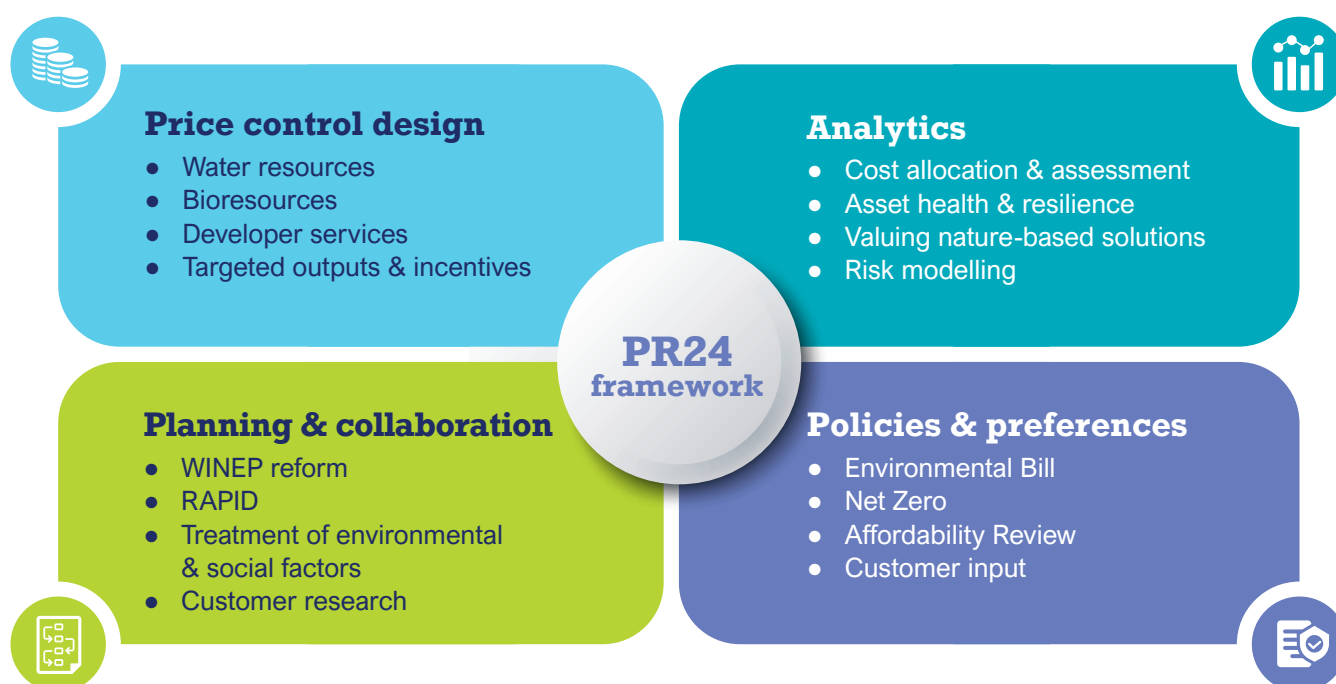
In this note we take a look at what we can learn about Ofwat's emerging thinking and areas of interest for the sector. What changes is Ofwat proposing? Where do we expect engagement and dialogue between Ofwat, companies and other stakeholders? And what will companies need to do to be prepared?

A wide range of 'live' issues

What are the key issues that will shape that framework? We expect that the focus will be on the following (see also Figure 1 below):

- **Price control design** issues including the treatment of **water resources, bioresources and developer services** activities. Ofwat is also likely to pay significant attention to the selection and calibration of the most appropriate outputs and incentives for PR24 and the long-term.
- Many **analytical** areas are likely to evolve. Given potential changes in the overall price control structure, we can expect **cost allocation and assessment** to continue to be a key determinant. There will be increasing emphasis on **asset health and resilience** and on **nature-based solutions**. Ofwat may also refer to enhanced **risk modelling** to inform its thinking.
- Industry-wide **planning and collaboration** will come to the fore. **WINEP reform** and the developing work of **RAPID** will help to align long-term planning and investment decisions, and companies are expected to work towards more consistent **treatment of environmental and social factors**. Ofwat also expects evolution of the way **customer research** is brought into the price control process.
- Finally, the context – both in terms of **policies and stakeholder preferences** – will continue to develop. We can expect the **Environmental Bill** to be passed and implications of **Net Zero** for the water sector to be clarified. CCW's **Affordability Review** will have implications for the treatment of water poverty. More generally **customer input** will continue to inform Ofwat's and companies' priorities.

Figure 1: CEPA assessment of key issues



¹ Ofwat (2021), "PR24 and beyond: Creating tomorrow, together", May.

Few firm decisions but a clear direction of travel

At this stage of the process Ofwat still has a great deal of flexibility on the eventual price control framework. Nevertheless, we can identify several areas in which the direction of travel for PR24 is clear, informed also by Ofwat's long-term goals for the sector.

In Figure 2 below we summarise some of the specific actions that we expect Ofwat to take (or at least consider), organised by:

- Which of **Ofwat's four goals** each action targets.
- What element of **Ofwat's toolkit** it would use to implement each action.

Figure 2: Ofwat's likely actions



Continuous improvement of the regulatory toolkit

As much as Ofwat is emphasising the need for fresh thinking and change, seasoned observers of PR19 will find much that remains stable. The regulatory regime retains many of its central characteristics, from high level features such as its five year duration to detailed points such as application of total expenditure benchmarking to base costs.

However, it will not be business as usual. Ofwat will expect active engagement in sharpening the focus on its chosen priorities. Companies will need to demonstrate in particular that they are:

- actively measuring and investing in long-term asset health and operational resilience;
- building natural capital considerations into their analytical toolkit; and
- focusing their attention on industry-wide challenges.

Ofwat's views on linking service levels to base costs – as well as high level commentary on productivity – signal that this will not ease pressure in other areas.

As ever, companies will be particularly sensitive to the assessment of efficient costs. We expect approaches developed during the PR19 review will continue to provide a basis for PR24 – Ofwat itself states that “PR19 base cost models provide a strong foundation for PR24”. Proposals for cost adjustments or enhancement expenditure will need to be well-evidenced. Key industry-wide issues are likely to include the read-across from any company-specific cost increases to the rest of the industry and the treatment of Covid-related bad debt costs.

Competition and collaboration

Ofwat is not only looking towards its regulatory toolkit. Companies will need to prepare to step up their role in facilitating markets for water resources and bioresources trading. There may also be a greater role for competition in provision of developer services.

At the same time, Ofwat expects greater collaboration across the industry in support of each of its goals. Some of this may be company-led: for example through greater emphasis on multi-party and multi-sector schemes to deliver environmental value and efficiency. In other areas the work may be led by Ofwat or other public sector players – though companies will need to participate actively.

Analytical approaches will need to evolve in order to fit in with Ofwat's vision for PR24. Proposed investments will need to reflect systems-based thinking and regional as well as local impacts on water resources, resilience

and the environment. All industry participants will need to keep abreast of latest techniques for valuing natural capital and evaluating nature-based solutions against other forms of investment. Companies will need to manage shared use of data with their need to protect customers' privacy and data security.



The public confidence challenge and customer input

Two years ago, Sir James Bevan defined the political challenge facing the water industry as a public confidence problem. These were his words:¹

"[...] political challenge is not just that one of the two major parties wants to renationalise the water industry, though Labour does, and has set out clear plans to do so. The challenge is deeper than that: it is that the water companies appear at risk of losing support more broadly in the country as a whole. You can see that risk in the fact that some Conservative ministers have been as critical of the water companies as Labour have. You can see it in the fact that the Financial Times, not normally a friend of nationalisation, has been critical of the industry in terms similar to those spelt out by Labour. And when politicians and the media are all saying the same thing, this is usually what the public are saying too."

In December 2020 Ofwat identified "achieving public confidence and affordability in the face of cost pressures" as one of the key challenges for PR24 and beyond.²

We expect further development of measures to address concerns around affordability. Water poverty is a prominent and topical issue following CCW's recent Affordability Review conclusions. Both Ofwat's second and third goals touch on this issue – but as yet there are no specific measures under consideration.

Companies will need to be prepared for further guidance here. The precise direction of travel will be set by the policy agenda – but may include regional or national measures alongside or instead of existing company-led social tariffs. It will be challenging to calibrate these and model their implications under different scenarios.

Ofwat – and indeed the companies themselves – have increasingly recognised that reflecting customers' views and giving them a voice is part of responding to the public confidence challenge. Three tools proposed

by Ofwat speak to how companies will need to reflect their social as well as economic purpose and listen to customers as they develop their plans:

- **Promotion of Ethical Business Regulation (EBR) themes.** While clearly signalling the relevance of this, Ofwat's latest view leaves the onus for *how* EBR is actioned with companies.
- **Set up a collaborative approach to customer research.** An increasing amount of customer research will be delivered collaboratively alongside other sector stakeholders, with the obligation for companies to set up customer challenge groups being removed.
- **Set standards for customer research.** The expectation is that companies will carry out more targeted research on specific issues according to industry-wide standards.

Streamlining regulation

It will be necessary to actively seek out ways to reduce the regulatory burden in order to deliver the desired outcomes while at the same time meeting Ofwat's aspiration to streamline the PR24 price review. This aspiration does not have the same status as Ofwat's four main goals. We expect Ofwat to continue to seek a settlement that challenges and stretches companies – but to take opportunities to do this efficiently.

Many of the actions highlighted in Figure 2 offer ways to reduce complexity. Greater visibility of future incentive rates should limit the need to start from scratch at each review period and help make reconciliations easier to manage. Sharpening focus on some outcomes and outputs naturally implies reducing emphasis on others. The process of regulation, too, may be improved – for example through a focus on the *quality* rather than the *number* of interactions between companies, Ofwat and customers.

Nobody expects this to be easy. Ofwat will have to make long-term commitments or less stringent demands of companies in specific areas – neither of which comes naturally to any regulator. The analysis and evidence base will need to clearly demonstrate that doing so can drive material net benefits for customers.

Industry will need to follow through on these areas of potential to avoid PR24 driving a further incremental increase in complexity.

¹ Speech by Sir James Bevan, Chief Executive of the Environment Agency, Water Industry Forum, Birmingham, 8 May 2019.

² Ofwat (2020), "PR24 and beyond: Future challenges and opportunities for the water sector", December.

About CEPA

We are a global economic and financial policy advisory firm that boasts some of the most sought-after UK economic regulation experts who are available. We are active across all regulated sectors, supporting and advising regulators, companies, Government and investors.

Recent highlights of our work include:

- Advising Ofwat on its emerging regulatory policy towards Developer Services and on the allocation of risk in PR24. Our advice was published in the form of two supporting papers to Ofwat's PR24 consultation.
- Supporting water companies' engagement in the PR19 process and in specific areas of regulation such as Developer Services.
- Developing an approach to defining and measuring water poverty in the sector. We have produced industry-leading reports for UKWIR and Water UK in this space in the past two years.
- Supporting Ofwat with the development and implementation of its approach to cost assessment for PR19.

We would be pleased to hear from anyone seeking to conduct exploratory analysis or challenge their emerging thinking in any of the areas discussed in this briefing. In the meantime, we plan to: publish a survey of the stakeholder landscape in order to identify where Ofwat is likely to further focus its attention over the coming year; and review the scope for new or improved analytical tools and techniques to further the debate.

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