# Ofwat's Draft Determinations for England and Wales water companies

17 July 2024

Briefing note

## 1 Introduction

On Thursday 11 July, Ofwat (the England and Wales water regulator) published its much anticipated Draft Determinations (DDs). As part of the PR24 price review, this sets out its provisional assessment of allowed revenues and performance targets for AMP8 (2025–30)—and will be of great interest to water companies, investors, and other stakeholders.

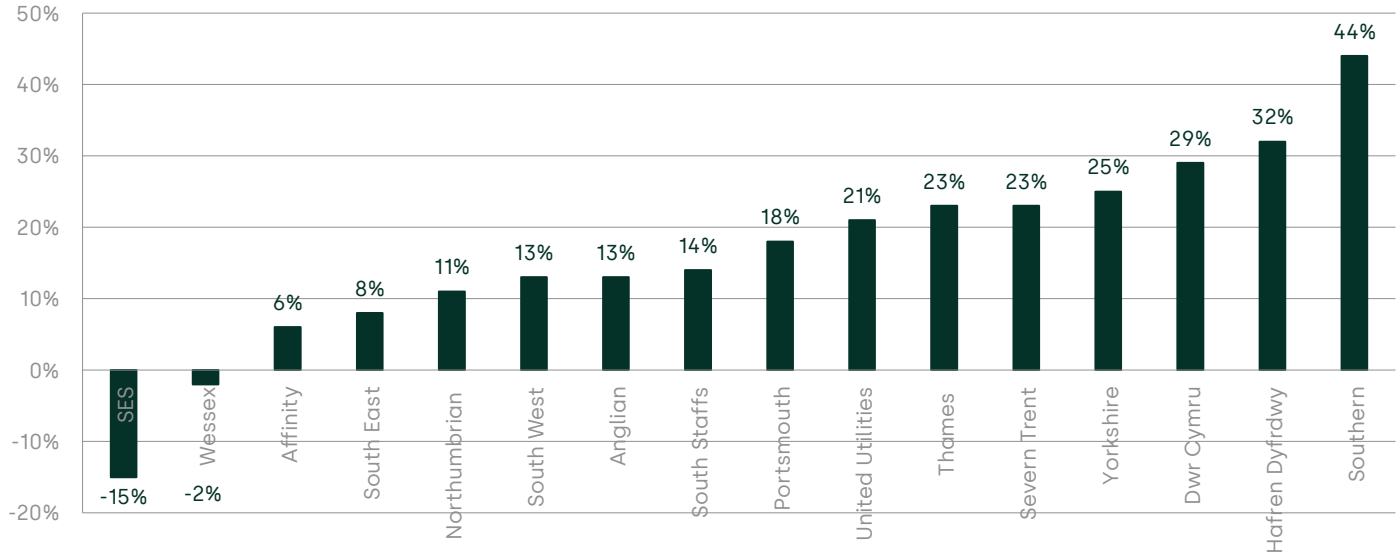
Have companies got all that they asked for in their respective business plans (BPs)? Now that the dust has settled, we explore the details. Companies have until 28 August to respond, with Ofwat planning to set out its final determinations (FDs) on 19 December.

## 2 Cross-cutting themes

### 2.1 Overall bill impacts

Under Ofwat's DDs, average bills will rise by £19 per year in real terms for water and sewerage companies. Southern Water will see the biggest increase in bills (+44%), while bills for Wessex and SES customers would fall in real terms between 2024/25 and 2029/30.

Figure 2.1 Bill impacts, % change from 2024/25 to 2029/30




Source: Ofwat.

## 2.2 Business plan assessment

Companies put forward their own proposals in 2023, as part of their BPs. As part of the DD process, Ofwat has undertaken an assessment of the quality and ambition of company BPs. The results are mixed.

- Two companies (Severn Trent and South West Water) have been categorised as 'outstanding'. They will each receive a financial reward of 30bp return on regulatory equity (but only if they meet certain commitments within the AMP8 period).
- Ten companies have been categorised as standard. Of these companies, eight will receive a 5bp reward. The other two companies will receive no reward or penalty.
- South East Water's BP has been found to lack ambition, resulting in a 15bp RoRE penalty.
- BPs submitted by Thames, Southern and Wessex are all deemed inadequate, with the companies receiving the maximum penalty of 30bp (as well as a tougher cost sharing rate of 60:40). These companies will have the opportunity to improve their assessment by FDs.

## 2.3 Overall cost allowances

Bills are increasing for a reason. The DDs allow for an increase in total industry spending (TOTEX) from £59bn over 2020–25, to £88bn in 2025–30. The increase in allowed costs reflects the large programme of enhancements that is needed to meet legal requirements, particularly in the wastewater network. Enhancement investment will increase three-fold, from £11bn to £34.5bn.

However, Ofwat has disallowed c.£16bn of TOTEX relative to company plans. This represents an overall 'haircut' to company BPs of 16% (versus a 11% challenge at the previous PR19 DDs). The level of challenge varies across the companies, with cuts ranging from 3% to 34% (after accounting for frontier shift and real price effects).[1]

### 2.3.1 Base costs

Much of the cut is driven by Ofwat's efficiency assessment. Ofwat relies on econometric cost benchmarking models to set a large proportion of efficient 'base cost' allowances at PR24, as it did at PR19. While Ofwat's modelling remains broadly similar to PR19, it has made several adjustments—with a view to more accurately capturing the drivers of efficient costs.

The DDs allow for a 14% increase in base cost allowance from £50bn at PR19 (over 2020–25) to £56bn for 2025–30.[2] However, the overall allowance is 7% lower than that proposed by the industry in their BPs. While South West, United Utilities and South Staffs received allowances above their BP proposals, the rest of the industry received cuts. Wessex has the greatest challenge in the industry—a 24% cut to its proposal, with Hafren Dyfrdwy and SES also receiving a 15% cut. Thames's base cost allowance has been cut by over £1bn.

Some of the difference in costs result from the proposed approach to energy costs in some companies' BPs relative to the approach now proposed by Ofwat (which applies an uncertainty mechanism).

In terms of the base cost approach, key decisions include:

- setting the catch-up efficiency benchmark at the upper quartile, in line with the CMA's PR19 redeterminations. (However, Ofwat may adopt a more stretching benchmark at FD);
- applying a frontier shift assumption of 1% per annum for base and enhancement expenditure (compared to an average frontier efficiency challenge of 0.6% in company BPs);
- introducing an energy cost true-up mechanism;
- accepting 28 of the 64 cost adjustment claims submitted by companies (with approved base cost adjustments totalling £1.5bn, relative to £5.4bn requested);

[1] Most strikingly, Thames Water's allowance has been cut by over £5bn relative to its latest business plan, while South East and Wessex have both received cuts of over 30%.
[2] Note the £56bn in base costs for 2025–30 is pre-frontier shift and real price effects.

- outlining an expectation that companies will replace at least 0.3% of their water mains network each year through base allowances (which is a significantly higher level of replacement than most companies assumed could be funded from base).

### 2.3.2 Enhancement

Assessing efficient enhancement expenditure allowances can be even more complex. Company BPs included £46bn of enhancement expenditure requests (£15bn in water, £29bn in wastewater and £2bn in bioresources)—more than four times the PR19 enhancement allowances (£11bn). 90% of the spend is linked to legal requirements (rather than more discretionary expenditure).

Overall, based on Ofwat's assessments across the respective enhancement areas, the industry will face a 26% challenge on proposed wastewater and bioresources enhancement allowances (with c.£23bn allowed), and a 22% challenge on water (with c.£11.6bn allowed).

A significant difference concerning the modelling approach at PR24 is represented by Ofwat's choice to rely extensively on scheme-level models, as opposed to company-level modelling.

Engineering-based assessments are applied in cases where econometric modelling was not applicable. Whether a deep dive or shallow dive approach is taken depends on the materiality of the costs and the level of uncertainty around the expenditure case. For deep dives, the efficiency challenge applied is proportional to the degree of concern.

On water, Ofwat has used a total of 28 water enhancement models. South East Water has the largest percentage reduction (64%), while several other companies (Bristol, Wessex, United Utilities and Welsh) experience reductions of over 30% of submitted costs.

On wastewater, Ofwat has proposed a total of 45 models: 38 on wastewater enhancement cost areas and 7 on bioresources. All companies, except Anglian, have a challenge to their planned spend. The biggest cut in expenditure (in absolute and percentage terms) is experienced by Thames. Wessex, United Utilities and Severn Trent have reductions of more than 20%.

## 2.4 Performance commitments and incentives

### 2.4.1 Performance commitment levels (PCLs)

In setting performance commitments (PCs), Ofwat's DD approach includes the following key elements.

- **Coverage of common PCs.** Ofwat has mostly confirmed the expanded scope of the 24 common PCs laid out in its final methodology and BP guidance (although river water quality will be reputational-only, and a common PC for severe water supply interruptions will also be introduced).
- **Bespoke PCs.** At PR19, there were 281 bespoke PCs across companies. Most of these have been condensed into the new common PCs above[3] or are captured under the new price control deliverable (PCD) mechanism (discussed further below). Of the 17 distinct bespoke PCs proposed by companies, only eight bespoke measures (across seven companies) meet Ofwat's criteria and will be progressed.
- **Baseline performance.** Ofwat's starting assumption is that companies will meet their PR19 PCLs by the end of AMP7 (unless there is compelling evidence to indicate otherwise). This may be a stretching assumption since most companies are underperforming relative to their assumed PCLs.
- **Approach to setting PCLs.** Ofwat has now provided considerably more detail on the assessment that it has conducted for each PC. There is no single overarching approach (e.g. what base buys, comparative assessment, or PCLs based on company-specific historical performance trends). Customer experience benchmarks will continue to be set on dynamic, relative assessments after-the-fact (i.e. based on outturn survey performance). The most important change here is for C-Mex: the benchmark will now be set relative to other sectors (as measured in the UKCSI all-sector average).

Ofwat has set PCLs in several areas that are considerably more stretching than most companies' BPs. Consequently, even for companies that have received a high proportion of their requested expenditure, there is a question as to whether they have sufficient funding to deliver the target performance levels. When combined with Ofwat's assumptions regarding the level of renewals funded from base, the proposed PCLs indicate a ramping up in Ofwat's expectations around what can be funded from base expenditure.

The PCs for which Ofwat has set noticeably more stretching targets include: per capita consumption; business demand; GHG emissions; pollution incidents; storm overflows; and biodiversity. Ofwat has also

[3] Most notably water quality contacts, external sewer flooding, biodiversity, bathing water quality, river water quality and operational greenhouse gas emissions.

set a more stretching deadband for the Compliance Risk Index (CRI) than most companies had expected to achieve.

### 2.4.2 Outcome delivery incentives (ODIs)

Most common PCs will have financial ODIs (i.e. rewards and penalties) attached to outturn performance. The potential rewards/penalties are mainly intended to be symmetric, and will have in-period annual settlements.

The problems that Ofwat has encountered in commissioning industry valuation research, and converting these valuations into ODI rates, are well documented. Ofwat had previously informed companies that the bottom-up valuation approach (which had initially been preferred) would be dropped in favour of a more top-down approach.[4]

Under this top-down approach, incentive rates for each PC have been largely based on equity return at risk (at 0.5% RoRE), adjusted to reflect customer and strategic priorities (0.4–0.6% RoRE). Four companies expressed concerns that the top-down methodology did not reflect customer preferences, but Ofwat has refuted this. Nonetheless, this could still be a key area of contention for some companies.

There are exceptions. Ofwat's view is that for biodiversity and greenhouse gas emissions robust external valuations of benefits do exist, so for these areas incentive rates are based on these valuations.

### 2.4.3 ODI protections

Ofwat has set out a variety of protections within the PCL/ODI package. Overall, to protect companies from 'disproportionate financial risk', Ofwat will apply the Aggregate Sharing Mechanism (see below, set at ± 3% RoRE), extended to include C-MeX and D-MeX (± 0.95 % of RoRE).

Caps and/or collars **have been applied to** just over 60% of all PCs. Caps and collars have been applied to all new PCs and all bespoke PCs (due to a lack of historical data), as well as all asset health PCs (to avoid incentivising large outperformance given the potential diminishing marginal benefits).

In line with its PR24 methodology, Ofwat will apply a collar at -1% RoRE for water supply interruptions, reflecting company concerns about a greater risk of underperformance than outperformance on this PC.

[4] Ofwat (2024), 'PR24 draft determinations: Delivering outcomes for customers and the environment', 11 July, p. 18.

As per its methodology, the only PC that Ofwat will apply deadbands to is the CRI. Ofwat has rejected use of deadbands elsewhere as it considers performance to be within company control, and because (in Ofwat's view) deadbands weaken incentives on companies to improve their performance when they are close to their PCL.

Overall, Ofwat's approach is intended to provide companies with an increased level of protection. However, given the apparent level of stretch within the PCLs, companies are likely to remain concerned about the potential for asymmetric risk under the ODI framework, particularly given the challenges companies have experience in meeting PR19 targets, and the generally higher expectations on what can be funded from base expenditure in AMP8.

### 2.5 Uncertainty mechanisms

Ofwat has taken a number of steps to tighten delivery requirements/penalise non-delivery and deal with uncertainty. For example, with the inherent uncertainty in large schemes, Ofwat is proposing an alternative approach to providing allowances. Where the scheme's requested value is greater than £100m and Ofwat has concerns around scope, cost, deliverability, complexity or if they are novel/complex technologies, one of two distinct approaches will be applied.

- **Enhanced engagement and cost sharing.** Where Ofwat has concerns over cost certainty it will apply a light touch enhanced engagement approach. Greater cost sharing also reduces adverse impacts of cost uncertainty by providing additional protection to consumers and companies in the event of overspend or underspend respectively.

- **Large scheme gated process.** If Ofwat has concerns regarding scope, complexity, deliverability or if the scheme is novel, there is a higher level of uncertainty. Such schemes require a higher level of customer protection and oversight. Hence, the large scheme gated process allows development funding up to the final submission (gate 3) at just 6% of total delivery costs. Revenue will then be logged-up after passing through a decision gate—either with a formal timetable or one informed by the company.

On storm overflows, Ofwat is proposing potential clawback of funding in certain circumstances, plus an **uncertainty mechanism** given unpredictability over the number of storm overflows schemes that will be required over the 2025–30 period.

The DD also provides greater clarity on Ofwat's approach to price control deliverables (PCDs), which is a mechanism intended to

clawback funding where companies do not deliver on their commitments. As part of its standardisation, Ofwat has specified two types of PCD incentive structures.

- **Non delivery PCDs** are a one-way mechanism that will return funding to customers for enhancements not delivered by the end of the price control period. These apply to all PCDs.
- **Time incentive PCDs** are two-way, rewarding companies for faster delivery (outperformance) and penalising them for late delivery (underperformance). These will apply alongside non-delivery PCDs, but only in the most material expenditure areas (storm overflows, phosphorus-removal, water supply, metering, and mains renewals).

The published list of PCDs is extensive and seemingly covers all PR24 enhancement expenditure areas, as well as some base expenditure[5] and some carry-over enhancement schemes from PR19.

### 2.6 Finance issues

Of particular interest to investors, Ofwat has updated the PR24 cost of capital compared to its 'early view' presented in the final methodology. Ofwat's application of its methodology results in a wholesale CPIH-real WACC of 3.66% based on a cut-off date of 31 March 2024. This compares to its 'early view' of 3.23%.

Ofwat has stuck relatively closely to the methodology outlined in its final methodology. The increase in the WACC is partially driven by the increase in interest rates that has been observed since the final methodology. However, there are also some unexpected positives for companies—in particular, Ofwat has chosen to 'aim up' on the cost of equity, adopting a point estimate of 4.80% (which sits at the higher end of its 4.19–4.88% range) to enhance investability. This translates into a 0.27% aiming-up uplift.

In terms of the cost of debt, the most significant change relative to the final methodology are: i) the removal of the outperformance adjustment of 15 basis points when estimating the cost of new debt; ii) an increase in the assumed share of new debt from 17% to 26%; and iii) an increase in issuance/liquidity costs from 10bp to 15bp.

Table 2.1 below provides a comparison of Ofwat's updated PR24 cost of capital with its 'early view' and Ofgem's RIIO-ED2 final determinations,

[5] For mains replacement, SES Water's statutory water softening and Thames Water's network reinforcement.

which were published in November 2022. (Ofgem is expected to provide its own updated view on the cost of capital in its Sector Specific Methodology Decision later this week.)

### Table 2.1 Cost of capital

| CPIH-real | Ofwat PR24 Draft Determinations | Ofwat PR24 Final Methodology | Ofgem RIIO-ED2 |
|---|---|---|---|
| Gearing | 55% | 55% | 60% |
| Total market return | 6.29%–6.87% | 6.00–6.92% | 6.50% |
| Risk-free rate | 1.43% | 0.47% | 1.23% |
| Equity risk premium | 4.86–5.44% | 5.53–6.45% | 5.27% |
| Asset beta | 0.31–0.34 | 0.32–0.34 | 0.349 |
| Notional equity beta | 0.57–0.63 | 0.58–0.64 | 0.759 |
| Return on equity | 4.19–4.88% (4.80% point estimate) | 3.67–4.60% (4.14% point estimate) | 5.23% |
| Cost of embedded debt | 2.46% | 2.34% | n.a. |
| Cost of new debt | 3.36% | 3.28% | n.a. |
| Issuance and liquidity costs | 0.15% | 0.10% | 0.25% |
| Return on debt | 2.84% | 2.60% | 3.01–3.07% |
| Appointee WACC (real, vanilla) | 3.72% | 3.29% | 3.90–3.93% |
| Retail margin deduction | 0.06% | 0.06% | n.a. |
| Wholesale WACC (real, vanilla) | 3.66% | 3.23% | n.a. |

Source: Ofwat (2024), 'PR24 Draft determinations: Aligning risk and return: Allowed return appendix', July, pp. 7–9, Table 1; Ofwat (2022), 'Creating tomorrow, together: Our final methodology for PR24, Appendix 11—Allowed return on capital', December, pp. 7–8, Table 2.1; Ofgem (2022), 'RIIO-ED2 Final Determinations Finance Annex', 30 November.

Overall, Ofwat's DDs mark an increase in the allowed rate of return relative to its 'early view' as well as relative to PR19 determinations (see Table 2.2).

### Table 2.2 Historical wholesale WACC allowances

| CPIH-real | Wholesale WACC |
|---|---|
| Ofwat PR24 draft determination | 3.66% |

| CPIH-real | Wholesale WACC |
|---|---|
| Ofwat PR24 'early view' | 3.23% |
| CMA PR19 redetermination | 3.12% |
| Ofwat PR19 | 2.92% |

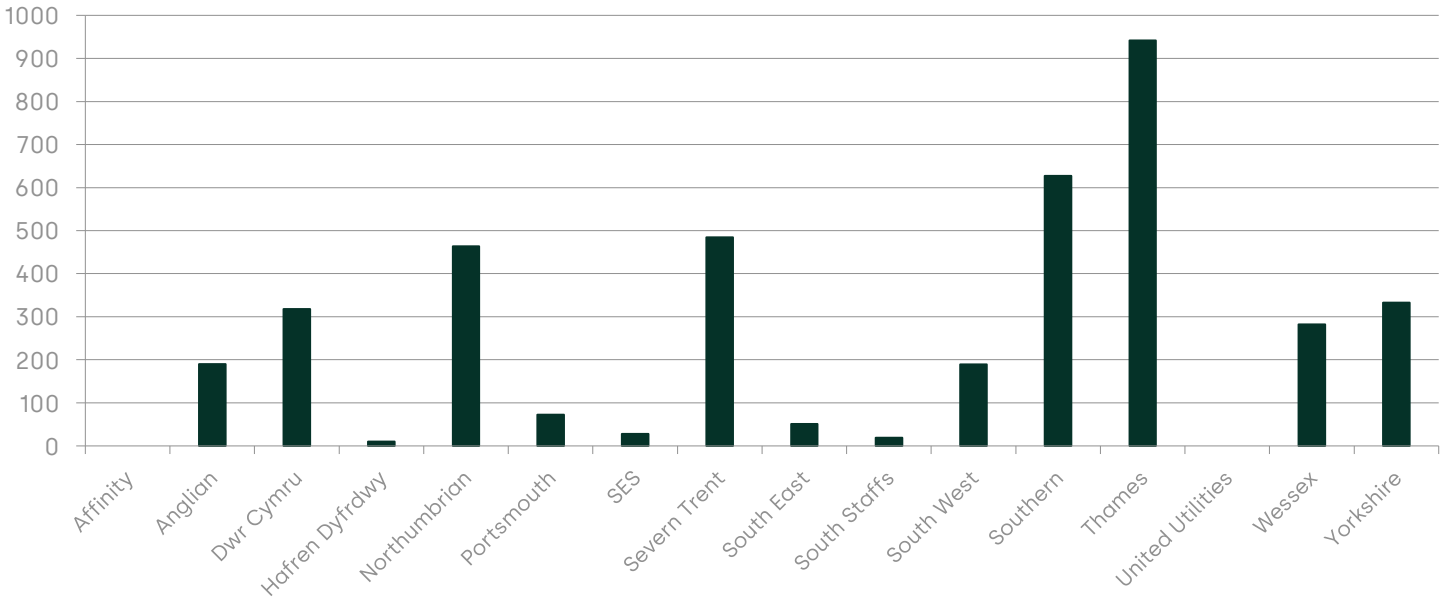
Source: Ofwat (2024), 'PR24 Draft determinations: Aligning risk and return: Allowed return appendix', July, pp. 7–9, Table 1; Ofwat (2022), 'Creating tomorrow, together: Our final methodology for PR24, Appendix 11—Allowed return on capital', December, pp. 7–8, Table 2.1; Competition and Markets Authority (2021), 'Anglian Water Services Limited, Bristol Water plc, Northumbrian Water Limited and Yorkshire Water Services Limited price determinations', Final Report, 17 March, p. 1099; Ofwat (2019), 'PR19 final determinations: Allowed return on capital technical appendix', December, pp. 4–5, Table 1.1.

### 2.6.1 Financeability

Ofwat has conducted its financeability assessment targeting a credit rating of Baa1/BBB+, in line with the assumption adopted by all companies (with one exception). Its underlying assumptions include an opening notional gearing of 55%, an opening proportion of index linked debt of 33% and a 4% dividend yield. The financeability assessment has been carried out excluding reconciliation adjustments for past performance. To maintain a gearing level close to notional, Ofwat has assumed that dividend yield for all companies is reduced to 2%, and in cases where gearing levels breach 57.5% new equity is injected. For new equity issuance Ofwat allows for a 2% issuance cost allowance.

The resulting financial ratios are relatively strong, with AICRs generally in excess of 1.65x. However, this does rely on the assumption that companies inject significant amounts of equity (see below).

Figure 2.2 Notional equity injections in Ofwat's modelling (£'000)



Source: Ofwat (2024), 'PR24 draft determinations: Aligning risk and return appendix', 11 July, p. 54.

### 2.6.2 RoRE risk ranges

Ofwat has provided its updated view on the balance of risk and reward under the provisional determination (in return on regulated equity, RoRE terms). It considers the overall balance of risk for the notional company to be broadly symmetric at -4.85 to +4.80% around the base RoRE.[6] As discussed in previous sections, companies are likely to take a different view on the underlying risk distribution and may question the assumptions underpinning Ofwat's analysis (e.g. the assumption that time-linked PCDs have symmetric risk, even though the rewards for early delivery are one quarter the size of the penalties for late delivery).

### 2.6.3 RCV run-off rates

Ofwat has, in a number of instances, chosen to lower the RCV run-off rates assumed by companies within BPs (where it considers there is sufficient financial headroom to do so). The result is to push cost recovery into the future, thereby reducing allowed revenues (and bill increases) in AMP8 (but with the corollary of higher charges in future AMPs). The resulting run-off rates are materially lower than those used at PR19, reflecting Ofwat's view that an average remaining asset life of 25 years is a reasonable assumption.

### 2.6.4 Cost recovery for public listings

Ofwat argues that some consortium-owned companies face challenges when raising new equity due to competing interest of investors. Given that companies will need to raise significant new equity and there are benefits associated with a public listing, Ofwat is consulting on providing funding for the costs of obtaining an equity listing through a log-up of costs to the RCV at PR29. This may be indicative of Ofwat pushing towards public listing as a potential solution for some of the challenges facing the industry.

[6] Ofwat (2022), 'Appendix 10: Aligning risk and return', December, p. 10.