



2024 PRICE REVIEW UPDATE

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WONDERFUL ON TAP



PR24 METHODOLOGY UPDATE



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SUMMARY

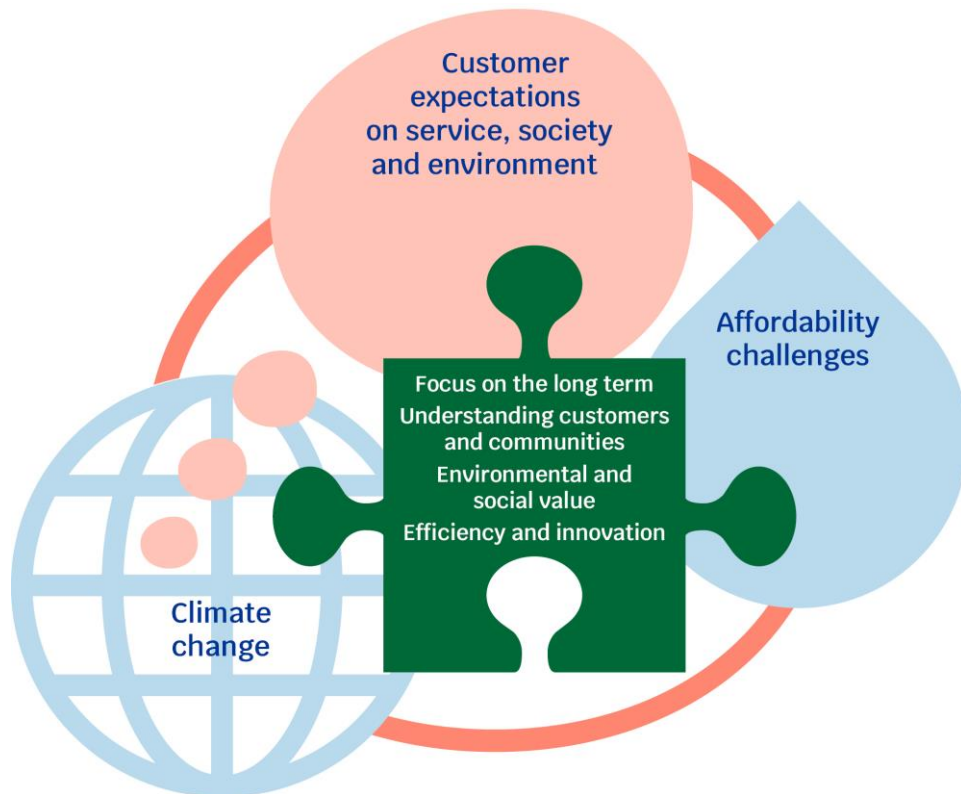
PR24 methodology is a complex framework but one that allows for long-term investment and opportunity to outperform

- PR24 is an **evolution** of PR19, not a revolution
- A **complex methodology**, but we are well positioned to manage this with our **established regulatory team**
- **Affordability** is front and centre, as expected
- There is increased **focus on long term investment**, in particular on the environment
- Companies will be expected to **deliver efficiencies and innovation**, with continuation of innovation fund
- There will be **winners and losers**, with strengthened incentivisation
- **Financial resilience** remains an important feature



OFWAT'S AMBITIONS

Ofwat set out four ambitions for PR24 which are in line with our expectations



Increasing focus on the long term

Companies should place their business plans clearly in the context of their long-term **ambitions**, and Ofwat will explore how to give **greater regulatory clarity** on what will happen in **future price reviews**.

Greater environmental and social value

Companies should be **key players in their communities**. Ofwat aims to **incentivise sustainable outcomes and behaviours that deliver the most value**, whether it be collaborating with local partners or working innovatively with customers and communities.

Clearer understanding of customers and communities

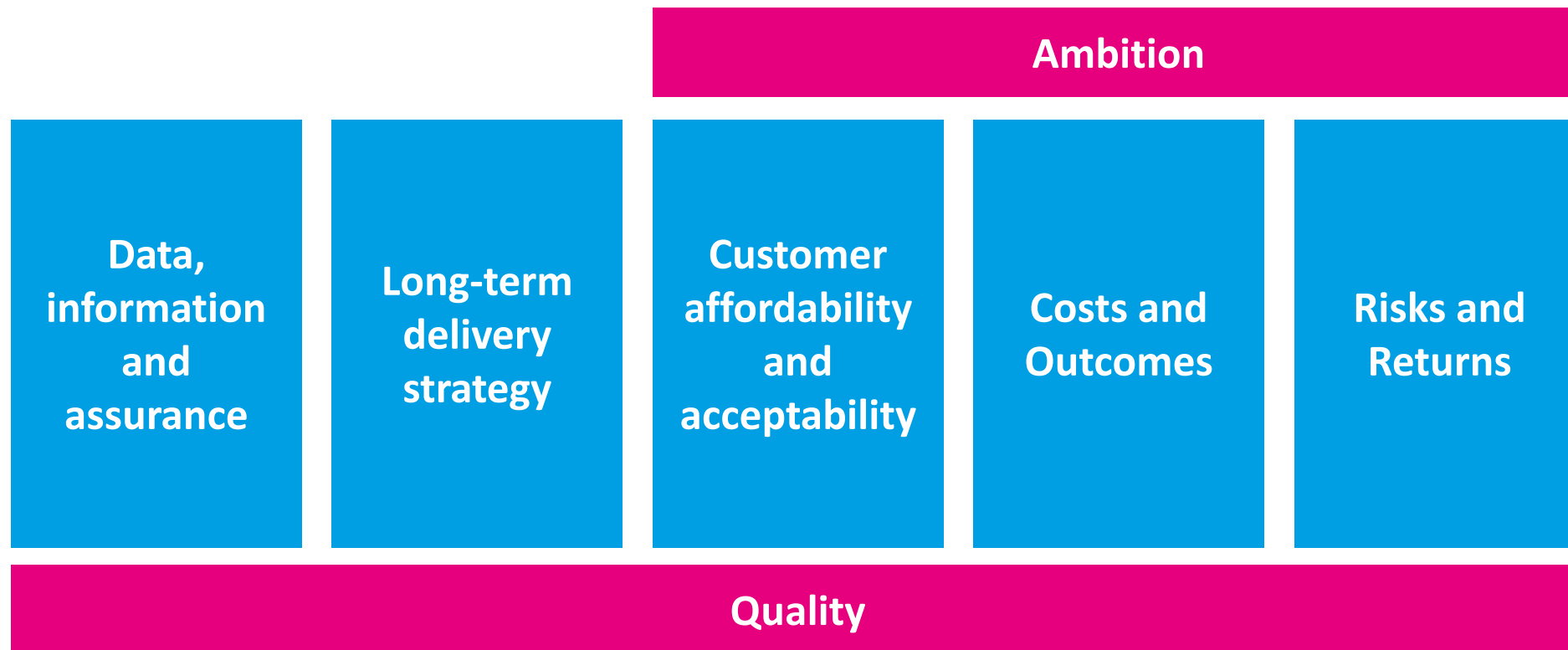
Ofwat plans to work with the sector to conduct **collaborative customer research**, to complement companies' own work with their customers.

Delivering improvements through efficiency and innovation

Companies need to **operate efficiently to create space to do more** for their customers and the environment.

APPROACH

Five key tests for assessing PR24 plans, which must be high quality and ambitious



Plans will be tested for both the level of **quality** and the level of **ambition** shown

Our aim is to deliver against these five tests while ensuring our plan is right for **all of our stakeholders in the long-term**

CATEGORISATION

We achieved “Fast-track” in PR19 which is comparable with “Standard” in PR24

		ODIs	Cost Sharing	Reward	WACC
PR24	Outstanding	70% of ODI benefit retained by companies	50:50	Reward 30bps	Protection between DD and FD
	Standard		50:50	Reward 0-10bps	No differentiation
	Lacking Ambition		55:45	Penalty up to 30bps	
	Inadequate		60:40	Penalty 30bps	
PR19	Exceptional 0*	50% of ODI benefit retained by companies	50:50	Reward 20-35bps	No differentiation
	Fast-track 3*		50:50	Reward 10bps	
	Slow-track 10*		50:50	No reward or penalty	
	Significant scrutiny 4*		50% and capped		

* Indicates the number of companies who achieved this status in PR19

CUSTOMERS

Putting customers' views at the heart of PR24 plans



Having an ambitious strategy on affordability will be a key requirement of any plan and is one of Ofwat's five tests

Customer engagement needs to be meaningful and plans will need to reflect the diversity of customers' and communities' needs, priorities and concerns

Ofwat is proposing each company has two open challenge sessions for customers and stakeholders in February-June 2023 and after final business plans are submitted in late 2023

ODI framework is here for the long term with a range of familiar common ODIs

Consistent with PR19

- Framework largely in line with PR19
- RoRE range remains at $\pm 1\text{-}3\%$
- Sharing of ODI rewards above **3% of RoRE**
- **Common and bespoke** ODI principles continue

New for PR24

- **Ofwat committed** to ODIs for the long term
- **$\pm 0.5\%$ RoRE caps and collars** on new and bespoke ODIs, with more symmetrical rewards and penalties
- **Enhanced ODI rewards** for frontier performance on four common ODIs
- Companies **keep up to 70%** of ODI “willingness to pay” value vs 50% for PR19
- Common **measures expanded** to 20* ODIs with a small number of bespoke ODIs per company



“The key outcomes in PR24 are also likely to be important in future and we intend to incentivise them in future price review periods”

Ofwat PR24

* Excludes Business customer satisfaction (for Welsh companies only) and Bathing water quality (only applicable to companies with a coastline)

ODI proposals are stretching but we have good early sight of what is expected

Consistent with PR19

C-MeX

D-Mex

Water supply interruptions

Compliance risk index (CRI)

Mains repairs

Unplanned outage

Customer contacts about water quality

Internal sewer flooding

External sewer flooding

Pollution incidents

Serious pollution incidents

Discharge compliance

Sewer collapses

Biodiversity

New for PR24

Storm overflows – indicated a starting baseline of an average of 20 spills a year, in line with our 2025 target

Operational greenhouse gas emissions (separate ODIs for water and wastewater) – we have a detailed Net Zero plan and are on track with emission monitoring and reduction plan

River Water Quality – we expect learnings from Green Recovery and Get River Positive plan to be helpful in phosphate reduction targets

BR-MeX – a measure of experience for business customers with details to be confirmed

Water Demand – Ofwat are considering combining Leakage, Per Capita Consumption (both common in PR19) and Business Demand into a single water demand performance commitment

Consistency in the base cost models and longer term focus on enhancement spend

Consistent with PR19

- **Base models** will be largely **in line** with PR19 – we're familiar with these
- An **efficiency challenge** will be applied as well as expecting **service improvement** as a result of base spend
- Companies to consider investment in the context of **25 year plans**

New for PR24

- Increased focus and supportive language on **long-term investment** requirements
- Ofwat is considering options for including **forecast costs** in the models
- **Future cost pressures** will be taken into account when setting efficiency challenges, e.g. additional complexity of ultraviolet treatment
- **Greater certainty** on longer term funding for **opex/IRE** focused projects, e.g. nature based solutions
- **Net Zero** – 'reduce' workstream funded, bidding competition thereafter
- More **flexibility on timing** of WINEP programme, enabling acceleration for some companies
- Site-specific **developer services** removed from the price control where there is strong competition – simplifying the model



Read our investor newsletter for an overview of our long term investment requirements - [HERE](#)

FINANCING

Opportunity to outperform on financing remains at PR24

Consistent with PR19

- Ofwat's indicative **RoRE risk ranges** for the notional company (excluding the base equity return) are **-5.00% to +5.25%**; Severn Trent's range was -5.1% to +5.8% at PR19
- Companies continue to **keep financing outperformance** with allowed cost of debt consisting of blend of embedded and new debt
- **Embedded debt allowance** will be based on Companies' **existing** Balance Sheets
- **New debt** will continue to be **indexed** to reflect changing interest rates
- Ofwat will use **CAPM** with cross checks to set the cost of equity

New for PR24

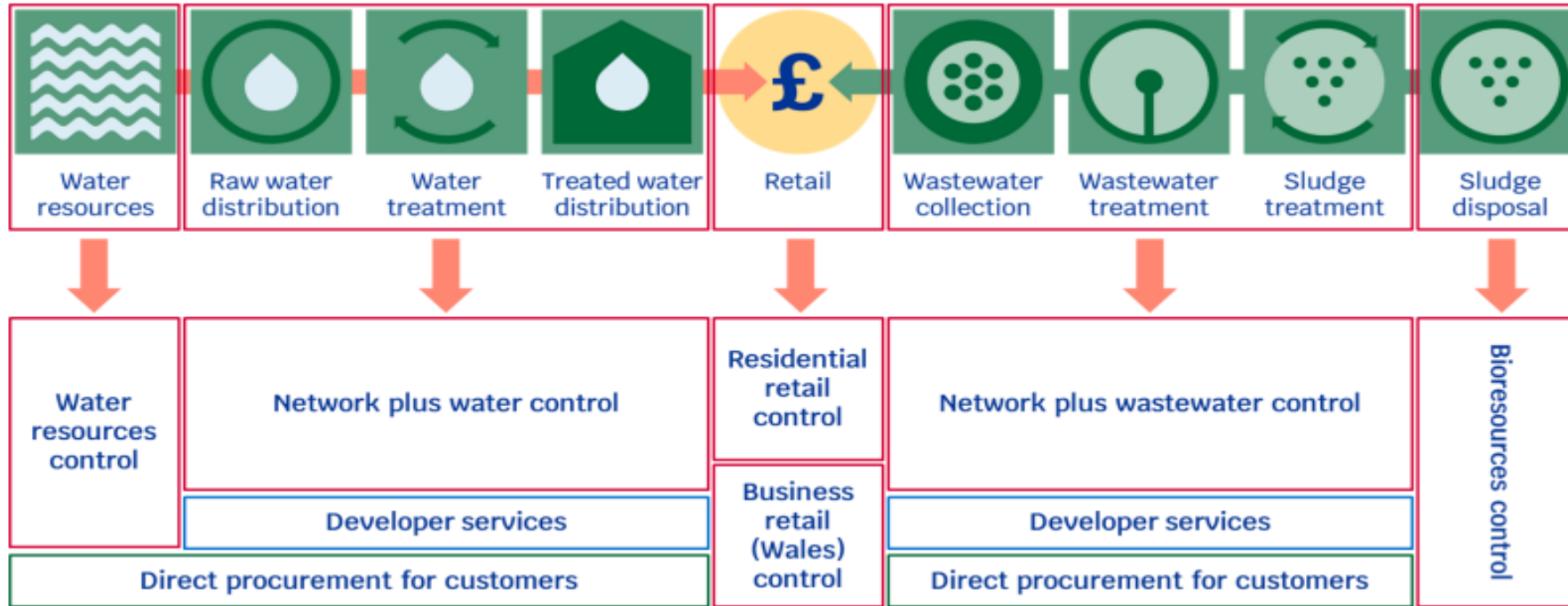
- Ofwat will consider some additional **credit metrics** which closely align to those used by Moodys and S&P
- Ofwat may set a **lower level of notional gearing** than 60% in December and **increase** the proportion of **index-linked debt** assumed
- Companies can **propose their PAYG and RCV run-off** rates, but an acceptable range for RCV run-off rates will be set
- Ofwat noted that the **risk-free rate** has been **increasing** recently
- Ofwat recognises the **important role of dividends** in equity financeability

Ofwat will give an early view of the Cost of Capital in December 2022

MARKET DEVELOPMENT

An evolutionary approach to increasing market competition

Consistent with PR19



No change to number of price controls

Most price controls will **continue to operate** as they did in PR19 – we are already familiar with the detail

Large projects expected to be taken through **Direct Procurement for Customers (DPC)** – threshold increased to **£200m** of lifetime totex

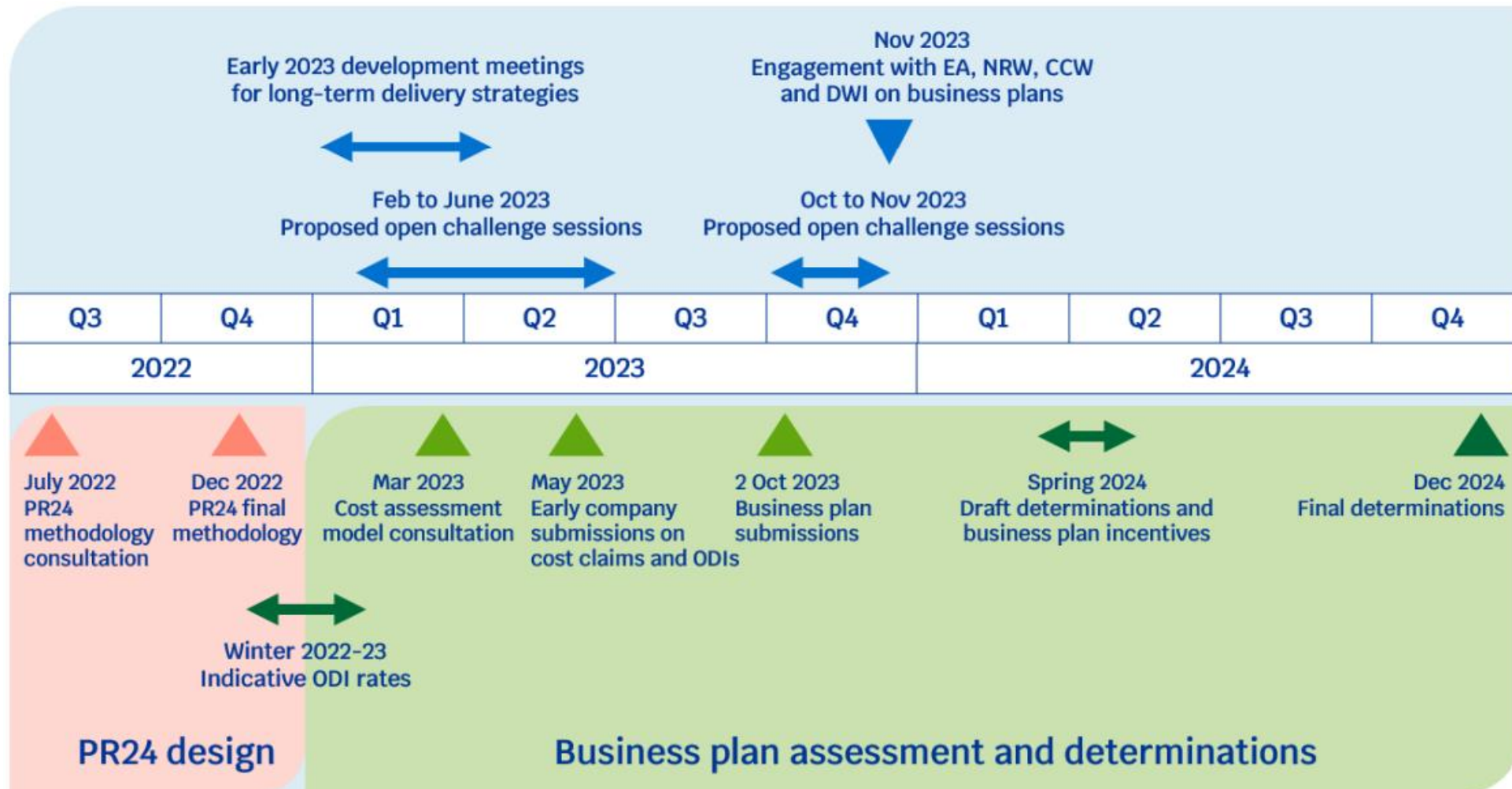
New for PR24

For **bioresources** price control Ofwat is proposing an **average revenue control** to bring the sector closer to “gate prices” used in other waste markets

We expect a further consultation on this in **September 2022**

TIMETABLE

Final Determination for PR24 is set for December 2024



CONCLUSION



Continuity: This is evolution not revolution. There is a lot of continuity in the draft PR24 methodology with PR19. We're familiar with the ODIs, the cost models and the method for setting the cost of capital.

Challenges: This is a complex methodology with stretching targets and a high evidence bar is required in return for the opportunities available in PR24.

Opportunity: There is greater opportunity for companies that want to push the sector's performance forward with stronger incentivisation and a focus on long-term investment.