

Regulatory Trends:

Looking to the long-term, a quiet revolution

December 2021

On 17 November 2021, Ofwat published a discussion paper on [long-term delivery strategies and common reference scenarios](#), as part of its work on the next price control (PR24) for the water and sewerage sector. This paper is interesting both in its own right and, we think, as an indication of the likely direction of travel for other economic regulators in the future.

To help inform your horizon-scanning and planning, we identify eight key takeaways:

Long-term view

One of the key themes for PR24 is an increased focus on the long term. With the introduction of long-term delivery strategies, Ofwat wants to take “a significant initial step” towards integrating long-term considerations more fundamentally into the price review process. Long-term delivery strategies will have five parts, namely:

- **Ambition:** setting out what the company aims to achieve over the next 25 years;
- **Strategy:** how the company will aim to meet this ambition over the next 25 years;
- **Rationale:** why the long-term delivery strategy represents the best way of meeting short- and long-term ambitions;
- **Foundations:** the key assumptions and uncertainties underpinning the long-term delivery strategy; and
- **Board assurance:** how the company Board has challenged management to deliver a high-quality long-term delivery strategy.

Long-term delivery strategies will focus on requirements for enhancement expenditure (rather than base expenditure) as these will have the greatest impact on achieving long-term performance ambitions. Going forward, Ofwat expects companies to demonstrate the need for enhancement investments with explicit reference to the long-term delivery strategy.

Continuity not reset

This increased focus on the long-term leads Ofwat to propose a fundamental shift in terms of the role of the price review. Rather than starting afresh or ‘resetting’ at each price review, Ofwat states that “five-year price reviews should be staging posts in the overall trajectory towards long-term outcomes” and “the aim of the price review [is] to establish the most appropriate five-year package of interventions to kick off the 25-year trajectory, taking into account future uncertainties, customer views and fairness between current and future customers”. Therefore, business plans at PR24 will represent the first five-year ‘chunk’ of the accompanying long-term delivery strategies, with the price control merely a sensible review point for those strategies. In future price reviews, companies will submit refreshed long-term delivery strategies, with a “clear line of sight” between the previous and refreshed strategy. For each regulated company, the long-term delivery strategy will therefore be a ‘living’ document which endures.

Clarity and alignment

Ofwat also wants a “clear line of sight” between other planning frameworks and PR24. Specifically, it wants a clear connection between company strategies under those other industry planning frameworks (e.g. WRMPs, DWMPs, WINEP etc.) and the business plan, and for all of them to be based on a consistent set of baseline assumptions about key internal and external factors. Whilst the industry frameworks referenced in the discussion paper are sector-specific, the point is obviously capable of more general application and likely to be attractive to other regulators.

Customer engagement

Ofwat expects companies to use evidence of customer preferences and priorities to inform their long-term delivery strategies, particularly in terms of Ambition, Strategy and Rationale. However, it goes on to recognise “the inherent limitations of [customer] research” and therefore to require companies to balance that evidence against other relevant considerations, such as efficiency and fairness between current and future customers. Given the weight to be attributed to customer evidence was a key battleground in the PR19 redeterminations – with companies arguing that Ofwat had failed to reflect the outcomes of the extensive customer engagement undertaken in its PR19 Final Determination – it is not surprising that Ofwat wants to say something at the outset about how such evidence should be treated in PR24. However, its somewhat vague references to “inherent limitations” and “other relevant considerations” seem designed to give the regulator some ‘wiggle room’ rather than achieving clarity.

Adaptive planning

Consistent with the UK Government’s draft strategic policy statement, Ofwat states that so-called adaptive planning should be at the heart of the long-term delivery strategy. It explains that adaptive planning can “facilitate the delivery of solutions that more closely reflect what later turns out to be required, compared to building traditional large infrastructure solutions on the basis of uncertain assumptions about the future, which risks unnecessary investment”. Ofwat describes a four stage adaptive pathways approach, namely: (i) for the ambition the company wants to achieve, identify the challenges and potential solutions that are likely to be needed under a range of scenarios to meet this level of ambition; (ii) evaluate the alternative options, and develop alternative pathways and triggers to help meet the future ambition in a range of plausible futures; (iii) select the core pathway, include short-term actions into the PR24 business plan, and set metrics to be monitored for future evaluation of the pathways; and (iv) during the price review period, monitor and evaluate the implementation of the pathways, and reassess future long-term options as future uncertainties change, for input into PR29 and beyond. Long-term delivery strategies will therefore contain a core adaptive pathway and a small number of alternative pathways – focused on key areas of risk and uncertainty – which could be triggered depending on how future uncertainties develop.

Comparability and common reference scenarios

Ofwat has developed eight common reference scenarios which it expects all companies to use to inform their long-term delivery strategy. These common reference scenarios are designed to help focus the price review on establishing the best possible trajectory towards meeting long-term outcomes – or, put more simply, to help assess whether the proposed activities are likely to be the right ones and are being delivered at the right time. They focus on four material drivers of uncertainty around long-term enhancement spending – climate change, technology, demand and environmental ambition – and are split into ‘high’ and ‘low’ assumptions about the future. Ofwat makes clear that they are not intended to be exhaustive or comprehensive, but represent “simple, plausible approximations of the future, and cover the most material areas of uncertainty around future ... activities and costs” and will be revisited at future price reviews. Companies are also expected to use wider scenario planning and other techniques to alleviate uncertainty and ensure long-term resilience in their regions to plausible future risks and eventualities. The purpose of setting out common guidance and expectations is to allow Ofwat to make comparisons across companies – which is of significant importance in water and sewerage as comparisons between companies have underpinned the way Ofwat has regulated the sector since privatisation. However, the approach is also of wider relevance as, for example, benchmarking is common in other sectors.

Strong evidence base

Whilst these are downplayed in the discussion paper, additional data requirements inevitably flow from Ofwat’s proposed new approach. Of particular note, companies must set out the estimated bill impact of their long-term delivery strategy, both for the core adaptive pathway and the alternative pathways, and there is a list of proposed long-term delivery strategy data tables at Appendix 2. As the discussion paper sets out minimum requirements – and clearly anticipates that companies will go further (e.g. to reflect their specific circumstances or to cover additional areas) – the additional burden on companies is likely, in fact, to be even more substantial.

Board assurance

Consistent with its focus on strengthening corporate behaviours in recent years, Ofwat expects each company's full Board to own and be accountable for their long-term delivery strategies. Specifically, the full Board is required to provide an assurance statement that explains how it has challenged and satisfied itself that the long-term delivery strategy: (i) reflects a long-term vision and ambition that is shared by the Board and company management; (ii) is high quality, efficient, and will deliver its stated long-term objectives; (iii) is based on adaptive planning principles and takes into account future uncertainties; (iv) has been informed by customer engagement; (v) secures long-term affordability and fairness between current and future customers; and (vi) will enable the company to meet its statutory and licence obligations, now and in the future. The Board should also provide evidence of where it has challenged company management and an explanation of the process it has used to arrive at the view that its long-term delivery strategy is the best it can be. Ofwat states that it is for companies and their Boards to determine how best to provide this assurance, including the role of external assurance.

This discussion paper therefore contains something of a 'quiet revolution.' Some of the proposals it contains are more fundamental and profound than their presentation might suggest, and they will certainly lead to greater consistency and traceability of company strategies, alter the dynamic of planning enhancement infrastructure, and increase the extent to which companies can be and are held to account. As such, we think they are likely to be of significant interest to other sector regulators – perhaps, most notably, Ofgem as it contemplates the next round of electricity and gas transmission and gas distribution price controls at RIIO-T3.

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