

Protecting consumers, promoting value and safeguarding the future

**Setting price limits for 2010-15:
Business plan information requirements
– responses to the consultation**

www.ofwat.gov.uk



Issue:

We sought the views of each company and other key stakeholders on:

- the range and scope of information for the draft and final business plan;
- whether guidance and line definitions are clear and succinct;
- whether there is any data that is superfluous or unnecessary (with reasons) and;
- the minimum requirements for the public domain versions of business plans.

Generally, respondents supported the range and scope of the information and agreed for the most part that guidance and line definitions were clear and succinct.

However, respondents raised concerns that the data requirements for PR09 were greater than those required for the 2004 price review (PR04) because of the additional data required for cost-benefit analysis, the reporting of greenhouse gas emissions and changes to the revenue information requirements. These issues are addressed separately below.

Respondents also raised concerns that we had not considered whether it was possible to reduce the data requirements. They sought further clarity on the guidance to certain issues, such as the reporting of special factor claims, and specific item definitions.

A number of companies suggested changes to the structure of the reporting requirements, which they thought would enable them better to set out the impact on customers or explain the relationship between various parts of the plan. Others requested additional data requirements or sections to be added to the plan.

One company raised an objection to the wording in the requirement that the Board certify that the plan “takes account of **all** the known issues”.

Our response:

We expect that each company's draft and final business plan will build on its strategic direction statement showing how its plan for the five year period (2010-15) takes account of its long term strategy.

At PR04 we collected data across all policy issues over a thirteen-year period (from 2002-03 through to 2014-15) and in some areas beyond, for the business plan and the financial model. This time, we are committed to only collecting the data that are necessary to set price limits for the five-year period to 2014-15; we have therefore, where it is appropriate, reduced the data

burden, by only requiring data for the eight years rather than thirteen years in the business plan.

We accept that companies may wish to adopt different approaches to setting out their strategy in the business plan. Each company should set out **its** plans in the most appropriate way to justify its strategy and signpost where these issues have been addressed if not in the format reflected in the guidance. It is a matter for companies as to whether they wish to support their plans with additional data or information that we do not specifically require.

We thank those respondents who have identified where we could improve clarity in the guidance and definitions. The revised information requirements will take these concerns into account. If, following receipt of the revised information requirements, further issues of clarity arise, we will address these through a clarification process. This will allow each company, reporters and auditors to seek clarification about the content and interpretation of the guidance or definitions. We will include a pro forma when we issue the final information requirements at the end of April.

We will amend the guidance relating to Board certification of the plan.

Issue: Asset inventory and modern equivalent asset value (MEAV) revaluation

Consultation views

Respondents raised a number of comments or issues concerning the data required for the asset inventory and its use. In particular, they commented on the use of expenditure as percentage of gross modern equivalent asset value (GMEAV) and sought clarification on how we plan to use this information, especially as the approach will not pick up investment in the current AMP4, so will not reflect current levels or future levels of investment. One respondent asked for additional guidance to understand the requirements for condition grading of large water mains, noting that as the UKWIR guidance is not yet published it is unrealistic to expect it to be complete for draft business plans. Another respondent said we should clarify the purpose of these tables and explain how this data will be used within the price setting mechanism. Companies can then consider the benefits of this data compared with the cost of collection (especially the age profile data).

One respondent queried whether it was practical to require each company to carry out a full re-survey of its asset base for the MEAV revaluation.

Our response:

We included the condition grading definitions in the consultation version of the business plan information requirements and companies should endeavour to apply these definitions. The UKWIR report containing further guidance on grading methodology will be published shortly.

The purpose of the asset inventory tables is to inform our assessment of whether the company has complied with its general duty to maintain the capability of its assets. They also provide a broad overview of the state of each company's assets, and how they have changed since we first captured similar data at the review in 1994.

We will use the GMEAV as a percentage of expenditure and compare it with to the condition and infrastructure age profiles to inform our setting of baseline expenditure assumptions. These will be based primarily on our assessment of how each company has applied the capital maintenance planning common framework.

We have always considered that sampling is acceptable for carrying out the MEAV revaluation, provided it is done on a statistically sound basis.

Issue: Capital cost estimating

Consultation views

Companies asked for greater clarity to explain how we will use the estimating scorecard. Some companies thought that the costs associated with implementing the scorecard approach would be far greater than the benefits that could be achieved through applying it, and that the scorecard appears to introduce a significant information burden. Respondents were also concerned about the consistency of scoring between companies and some saw the scorecard as a highly prescriptive, intrusive and inappropriate way for a regulator to be determining the approach to capital procurement.

Our response:

The comments raised about the information requirements were also mirrored in the methodology paper responses. We have therefore set out our response to these issues in the key themes and responses to the methodology paper consultation.

We can confirm that we only require each company to complete the scorecard for approximately 20 projects for water and 20 for sewerage service. We will

update the part C5 guidance to clarify how companies should decide on the exact number of scorecard assessments.

Issue: Cost benefit analysis – data requirements

Consultation views

In light of the uncertainty surrounding aspects of cost benefit analysis (CBA), some companies wanted to know how much sensitivity testing we require. One company suggested that we consider using confidence grades to indicate the accuracy and reliability of data.

A few companies were concerned about the data burden and the prescriptive nature of data collection and thought that the CBA information requirements should be free format, leaving each company to present its case.

Our response:

We expect each company to take account of the uncertainty surrounding both the impact(s) of schemes as well as monetary valuations of benefits when deciding upon its optimal investment strategy. We have used confidence grades traditionally to indicate the accuracy and reliability of outturn or actual data as reported in the June return, and we are not persuaded that they are the most appropriate method for tackling uncertainty in CBA. Instead, we will expect each company to address the issue of uncertainty in estimates using tools such as sensitivity analysis.

Each company should highlight significant outcomes from the uncertainty analysis as part of the supporting evidence to accompany their CBA tables (tables 8.1 and 8.2). It is up to each company to decide on the best form of evidence to present in support of its proposals. Where appropriate, the company may opt to submit ranges of values to accompany the expected values.

We decided on the format of data collection following discussion with companies and in light of views expressed at the CBA workshop held on 9 October 2007. As a result, it now includes, for example, columns for schemes that could not be assessed using CBA because the company was unable to place a value on the benefits such as some aspects of continuing base operating expenditure. All enhancements must be assessed as outlined in our response addressing CBA methodology below. We will include further guidance in the information requirements.

It is essential that there is structure to guide companies on the data collection so that we can be sure we get sufficient and relevant data that will allow us to assess each company's investment proposals. The format of the tables is flexible to allow each company the freedom to report on the CBA methodology that is appropriate in its case. The structure of the tables allows a top-level commonality across companies. However, we also require supporting evidence alongside the tables. It is for the company to decide what evidence will explain and justify how it has derived its investment programme.

Issue: Cost benefit analysis – methodology

Consultation views

Several companies expressed the opinion that CBA is not appropriate for base expenditure to maintain existing service levels. They wanted us to clarify our requirements for justifying stable serviceability. One company thought that CBA is appropriate for justification of the overall plan but not for meeting requirements at individual project level.

One company commented that a default time period of 40 years for NPV analysis was not appropriate for ME&I (mechanical, electrical and instrumentation) assets which have shorter lives.

One company thought the plotting of projects as a graphical presentation was an unrealistic expectation. The company was also uncertain as to whether this should be a graphical representation at the project or sub programme level.

Our response:

CBA is “best practice” and, as such, should be used for all business-as-usual investment decisions, such as those concerning many assets categorised as management and general. Although it may not be possible to perform bottom-up CBA on these assets as their benefits cannot be directly valued by consumers, they still contribute towards base service.

Companies should adopt the most cost-beneficial options to deliver base service. A company must therefore demonstrate that any departure from existing levels is in line with consumers' preferences or, where no change is proposed, that consumers do not wish for a change in existing levels. If a company has concerns about its ability to assess accurately the benefits of schemes, then it should supply additional evidence to explain, and justify, the investment in these areas.

CBA is appropriate for justifying the overall plan, but it is also required at individual project or sub-programme level to demonstrate how the plan has been built up. It will also identify the costs and benefits of any proposed investment that does not align with the overall plan.

The default of 40 years for NPV analysis for CBA is an optional time horizon. If a company wishes to use other timeframes then it should explain its decision. In practice, many schemes or programmes will include assets with a wide range of design lives. For those assets which have shorter lives, we would expect companies to include for replacing or maintaining them at the appropriate points within the overall timeframe of the CBA. Accordingly, we do not see the proposed default period of 40 years as unsuitable.

We expect each company to plot projects at either project or sub-programme level, dependent on the level of its analysis. This will give an overview of the impacts of projects and demonstrate the extent to which a company's plan is in line with consumers' preferences. It will also be possible to identify investment that is significantly out of line with consumers' willingness to pay. There may be instances where a company cannot value the benefits of every project or sub-programme individually. Thus, there may be some parts of the investment programme that cannot be plotted. However, this graph is a top-level representation of the costs and benefits of investment proposals. Further evidence will be required to demonstrate that these proposals maximise benefits relative to costs.

Issue: Greenhouse gas emissions

Consultation views

A number of companies raised concerns about providing data on non-carbon greenhouse gas (GHG) emissions, whether there are sufficiently robust methodologies to produce non-carbon GHG emissions and how the data will be used. Companies raised questions over embedded emissions and how to calculate them. Companies also raised concerns over whether we as a regulator needed to set targets for reductions given the carbon commitment scheme.

Our response:

Providing data on GHG emissions is an important element in understanding the environmental impact of the water industry. It provides a platform from which emissions can be managed in an effective manner and places a responsibility on each company to respond to the challenges that climate

change presents. Our approach to carbon targets is outlined in our methodology paper.

The methodology proposed for calculating direct and indirect emissions follows both Defra and UKWIR guidelines. These documents represent the best available information and have been agreed as the most effective way forward. We recognise that there will be uncertainties in the data and expect companies to comment on the quality of their reporting.

The Carbon Reduction Commitment (CRC) scheme only takes emissions from energy use into account. In the water industry this covers approximately 80% of all emissions. It is important that all major emissions are taken into account including GHG emissions not covered by the CRC.

Separating emissions by type (CO₂ and non-CO₂) for the operational phase of an asset should not add to the reporting burden, as the data is gathered for each gas independently (as outlined in the Defra and UKWIR guidelines). In addition, data has to be gathered separately to meet CRC commitments. For the build phase of an asset, we will simplify the reporting requirements to total greenhouse gases for the build phase.

There is some uncertainty over calculating embedded carbon. However, the contribution from embedded carbon can be significant and should be included. UKWIR will be publishing guidance shortly on embedded carbon and it is anticipated that the water industry will adopt this.

Issue: Overlap programme

Consultation views

Some companies expressed a view that the overlap proposals were overly restrictive in other respects. A few companies thought that capital maintenance projects should not be excluded from consideration in an overlap programme, while one company considered the 20% limit on the capital expenditure in 2010-15 to be too low.

Our response:

Each company can make a case for capital maintenance projects to be considered as part of the overlap programme where there is a clearly defined output. The overlap programme may be appropriate for large maintenance projects that span two price review periods because of the timescales required to design and deliver the output. It should not be used to seek

regulatory commitment for generic maintenance requirements or additional base operating expenditure. We will add the additional lines required.

We believe that it is reasonable to expect that capital expenditure for which we will give confirmation will be no more than 20% of the enhancement expenditure in 2010-15. If a company makes a case for expenditure beyond this guideline, our view will be informed by the strength of the justification advanced and consideration of the degree to which it may constrain future decisions.

Issue: Efficiency and operating expenditure

Consultation views

A number of companies requested that we set out our requirements on special factors. One company suggested that on the basis of materiality we should not expect companies to estimate separate efficiency factors for enhancement operating expenditure and we were missing an opportunity for simplification. Another company also raised the issue that the operating expenditure incentive multiplier was not included and visible in the information requirements.

Our response:

We will be clarifying our requirement for special factors shortly.

We believe that there is greater scope for efficiency for operating expenditure associated with enhancements compared with operating expenditure relating to base service. Therefore, we will continue to ask each company to estimate separate efficiency factors for enhancement and base operating expenditure.

We will update the final business plan information requirements to include the calculation of the operating expenditure incentive multiplier.

Issue: Capital maintenance and serviceability

Consultation views

Companies generally supported the proposals for aligning the business plan commentary with the output from the UKWIR study, Asset Management Planning Assessment Process (AMPAP) for assessing capital maintenance plans, but wanted clarification about the approach that we will adopt to actually score their plans.

Several responses included concerns about the unreliability and variability of the unplanned maintenance indicators. Respondents thought that clarity was needed to explain how this information will be used.

Respondents also queried the use of reference levels and control limits and the clarity of the process in deciding final determination outputs.

One respondent commented that there is an inconsistency in the timeframes set out for forecasting outputs and expenditure.

Companies also wanted clarification about the flexibility within the proposed structure of part B3 and the use of six-year and seven-year averages.

Our response:

We expect each company to apply fully the principles of the common framework and we intend to develop our scoring process in line with the guidance set out in the AMPAP. Companies should make sure that their business plans are well evidenced and based on sound asset management.

We have reviewed our proposals for unplanned maintenance projections and we still think it is important to have a measure of non-infrastructure asset performance within the suite of indicators. We have noted the concerns about the immaturity of the unplanned maintenance indicator and confirm that it will be used as supporting information for our annual serviceability assessments.

Reference levels and stable trends within control limits will form the basis for setting and assessing the final determination serviceability outputs. We have added forecasts of reference levels and control limits to improve transparency and ownership of serviceability outputs. We are looking to each company to maintain the service capability of its asset systems at an optimal economic level to safeguard the flow of services to customers into the future at a tolerable level of risk and price acceptable to customers. We expect each company to follow the approach to reference levels set out in RD15/06, 'Assessing serviceability'.

Where the best level achieved is inappropriate because it is sub-optimal or atypical we expect the company to set down its reasoning for setting a different, optimal figure and associated control limits. We may challenge this and put forward an alternative with a view to reaching agreement for the final determination.

We have reviewed the timeframes set out for forecasting outputs and expenditure. It is important to understand capital maintenance outputs and expenditure within the long-term context. Therefore, all water and sewerage base service outputs and expenditure are required for both AMP5 and AMP6. The base service infrastructure expenditure data (in tables B3.5 and B3.7) are needed for IRC calculation purposes when applying the 15-year forward look approach. The quality and environmental compliance and customer service outputs may be subject to change (for example, as a result of a change in customer preferences or quality standards). Therefore, we only require output and expenditure forecasts for AMP5.

Two companies queried why the capital maintenance historic expenditure download would not include the 2007-08 data (that is, be based on a seven-year average as soon as the June return data for 2007-08 is available). This is possible but would result in the data line being unpopulated until June 2008. This means that whilst preparing the plans (between now and mid-June) companies would not have the historic reference point which they should refer to in their plans. Therefore, for transparency reasons we intend to populate the six-year average download into the information capture system for the draft business plan and then update it with the seven-year average for the final business plan.

Expenditure in tables B3.5 to B3.8 has to be set out annually, so that we can include, the investment profile in the financial model. The commentary does not have to set out the annual expenditure. Moreover, the guidance states that a company can group together investment drivers which span asset types. The associated expenditure must be proportionally allocated into the correct category in line with the RAG. The imposed structure is intended to aid comparability and to increase the effectiveness of our assessment of the business plans.

Issue: New consumer service measures

Consultation views

A number of companies mentioned the introduction of a data requirement covering new consumer service measures and how they will be used in price setting.

Our response:

We have continued to work with an industry working group to develop new consumer experience measures. Our consultation on the business plan information requirements signalled our intention to include additional data lines (in table B3.1) to capture information on these new measures. We had anticipated collecting this data in the final business plans so that each company's forecasts for improving consumer experience could be exposed. It was not our intention to use this information to set outputs at PR09.

We accept that, given the timetable for introducing and piloting the new measures, it would be difficult for each company to forecast future performance on these measures even by the final business plans. Therefore, we have removed these data lines to reduce the data burden on companies. Instead, companies may wish to include their approach and aspirational targets for improving consumer experience over the period 2010-15 and beyond in the commentary.

We have written to companies on the consumer experience measures developed with the industry working group with proposals to pilot these measures in every company during 2008-09.

Issue: Supply/demand data requirements and reporting of water efficiency

Consultation views

Respondents commented that supply/demand requirements include sustainability reductions for schemes not to be funded through the price review, but through a yet to be determined process with the Environment Agency. They questioned whether it was therefore necessary to include this in the business plan if a company obtains funding through a different route. A small number of companies were concerned about reporting estimates of water saved through water efficiency activity.

Our response:

We will include in each company's price limits the capital and operating costs of all appropriate schemes to meet supply/demand deficits.

However, each company must identify any compensation it expects to receive from the Environment Agency for schemes to replace water lost to sustainability reductions. We will offset this compensation against a company's investment proposals. The Environment Agency will fund this compensation through increased abstraction charges to the water companies, which in turn will lead to increased operating expenditure.

We will collect cost data for these schemes to check for consistency with the compensation to be paid and any associated increase in operating expenditure. This will also allow us to assess the impact of compensated sustainability reductions on balancing supply and demand.

In assessing each company's performance in meeting its duty to promote water efficiency we look at both the information it provides to consumers and the estimates of water saved through the activities it promotes. It is likely that future water efficiency targets will continue to focus on both aspects of companies' water efficiency activity. Therefore, companies should treat the qualitative and quantitative reporting of their water efficiency activity as being equally important.

Issue: Reporting of private sewers

Consultation views

A number of companies sought specific guidance on how they should allocate costs associated with a transfer of private sewers to companies. Two expressed their own views on which cost categories companies should use and a further company commented on the possible impact a transfer would have on indicators of performance and service levels such as pollution incidents and sewer flooding.

Our response:

Defra's Statement of Obligations (December 2007) states that, subject to Parliament's approval of the regulations that would make the transfer of private sewers a statutory duty for sewerage undertakers, the Government expects the regulations to be in place some time between 2010 and 2015. Consequently, it is unlikely that we will be able to make specific provision in price limits for an obligation the exact extent and timing of which are not known with any certainty. We expect that the AMP5 change protocol procedure, which is being developed to manage uncertainty, will be the vehicle to take account of the costs of additional obligations when they become certain.

Therefore we do not expect companies to include proposals in their business plans regarding private sewers. However, if as part of setting its plan in the context of its long term strategy a company wishes to indicate costs and forecast levels of maintenance and enhancement activity associated with the transfer it may do so in its commentary. It should set out any key assumptions underpinning the forecasts.

We acknowledge that the transfer of private sewers will have an effect on the number of pollution incidents, sewer blockages and collapses etc for which a company is responsible. A company may, if it wishes, include in its commentary estimates of this impact on the forecast base levels of service in 2014-15.

Issue: Forecasting revenue requirements and the revenue correction mechanism

Consultation views

Companies raised concerns that the data required was burdensome and that they required early sight of the tariff basket model. Without sight of the tariff basket model companies were unsure of the accuracy of the forecasting and wanted clarification that it would not be used to generate expectations of specific tariff levels in future years.

Our response:

We have provided each company with a “beta” Excel version of the tariff basket model to help it understand how inputs will be used to derive revenue forecasts. We believe that this model will lead to robust revenue forecasts. A more sophisticated approach would be unlikely to make forecasts more accurate. Increasing the data burden on companies and the complexity of the model might generate slight improvements but these would be irrelevant given the uncertainty that would remain in forecast information.

We will clarify our guidance on how companies should enter charging information, including household unit rates. In light of companies’ concerns we will revise the non-household information we require. Each company will be able to choose the thresholds that it reports, although as a minimum all companies must separate tariff basket and non-tariff basket revenue. Companies will still be required to report revenue separately for potable water, non-potable water, sewerage, and trade effluent, but different thresholds may be used in each case.

We are not collecting information on tariff structures and we will continue to deal with this in the annual charges setting process. However, we will expect each company to maintain the balance of charges between customer groups as set out in its business plan. A company would need compelling new evidence about cost reflectivity in order to change the balance from that described in its business plan.

Issue: Public domain version of the business plan

Consultation views

In general, respondents welcomed our decision to allow each company to choose the format for the public domain and the minimum information requirement.

CCWater:

- called for some additional information to place the public summary in context;
- raised concerns that data on external flooding had been deleted from this part of the business plan;
- requested that we publish projected bill information based on a sample rateable value charge and a sample metered charge; and
- called for additional financial information and provided some suggestions on the format of part A.

A small number of companies requested that the public domain version should be published at a later date and not at the same time that companies submit part A to us.

Our response:

The data requirements as prescribed are the minimum that we would expect each company to publish. We have set out not to prescribe or limit either the content or the style of the public domain business plans. This is a matter for the company and its customers – and an area where CCWater has a valid role to play. The bill information prescribed in the tables is that which our tariff basket model can produce directly. Whilst we have no objection to a company providing illustrative bills on the basis of a rateable value charge or consumption if it considers this will aid its consumers' understanding, forecast figures need to be interpreted with caution, because the actual figures will depend on each company's final charges schemes and our approval, which we cannot prejudge.

We would expect each company to place its activity in context, without us further prescribing additional data requirements.

We see no reason to delay publishing part A in the public domain. Although the draft business plan is subject to discussion and query between us and the companies, it is important that other stakeholders are allowed sufficient access and time to consider and comment on the companies' plans and to raise any questions with the companies.

External sewer flooding outputs will be included in table A3 of the public domain information.

Issue: PR09 projects database

Consultation views

Whilst there was some recognition that it was desirable to include a projects database to accompany companies' business plan submissions as was the case at PR04, responses indicated two key concerns. Some companies remarked on the lack of visibility so far and requested that the database be made available at the earliest opportunity to enable familiarisation and systems checking to be carried out.

A number of companies considered the facility to upload data automatically to minimise the need for manual entry to be very important, particularly given the new requirement for data on CBA, GHG emissions and the introduction of the estimating scorecard.

Our response:

We agree it is vitally important to engage effectively with each company in developing the PR09 projects database. In January, we launched a series of information updates to companies. The first of these advised companies of system requirements and set out our timetable for the work needing to be carried out for the rest of the year. A beta version of the database was released to companies at the end of February 2008.

We also recognise the desirability of easing the significant workload on companies in populating the databases. First, we have offered companies the option of automatically uploading data for them as long as it is provided in the structured format that the Environment Agency has developed. We have also endeavoured to maximise the use of drop-down menus for those data fields where selection from a limited number of options is possible. Finally, data validation checks are being built into the database which should help prevent some common errors.

We will update the guidance to clarify that each company can choose to bundle projects where the individual cost of the project is less than £500,000.

For capital maintenance projects companies can also choose to bundle schemes that exceed the £500,000 threshold where this is appropriate (for example, where individual projects are not yet identified and planned or where projects are based on similar drivers or outputs). Where the information requested in the projects database has already been provided in part B3 of

the business plan then the company can cross reference the information to avoid duplication.

Issue: Reservoir and timetable

Consultation views

Companies requested that we set out a definitive timetable for releasing the draft business plan information capture system, financial model and the tariff basket model. They also raised concerns over the robustness of Reservoir and the functionality.

Our response:

Since the first issue of Reservoir we have worked with companies through workshops to make sure that the system meets companies' requirements. We have improved facilities to transfer data to Excel and we have constantly offered support to all companies to help them get the system installed on their networks. We are working hard to make sure that future systems are robust and bring increased functionality and benefits to companies.

The benefits of Reservoir ultimately mean that the business plan information capture system (ICS) and financial model are integrated to reduce the data burden.

We are working to release the ICS for the draft business plan, the financial model and the tariff basket model on 9 May. The system design will also allow us to issue enhancements, should they be required, during May and June, which will not impact on the completion of the capture system by companies.

We will issue the final draft business plan information requirements by the end of April 2008.



Ofwat, Centre City Tower
7 Hill Street, Birmingham B5 4UA

Phone: 0121 625 1300 Fax: 0121 625 1400
Website: www.ofwat.gov.uk
e-mail: enquiries@ofwat.gsi.gov.uk

April 2008

© Crown Copyright 2008