

Protecting consumers, promoting value and safeguarding the future

**Setting price limits for 2010-15:
Framework and approach
– responses to the consultation**

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Foreword

In October 2007, we consulted on our methodology for the 2009 price review; the consultation closed in January 2008.

While the consultation paper was drafted with the water industry in mind, it was important to us that our proposals were understood by all stakeholders. In the consultation period we held two workshops in Birmingham – one focusing on the issues of concern to the water industry and the other presenting the topics which we felt that other stakeholders wanted to understand. Subsequently, we met with other stakeholders at various opportunities.

We received 51 formal responses from a wide variety of stakeholders. We have taken account of these, along with the comments made at the consultation workshops and meetings, to refine and challenge the policies set out in our methodology. The responses are now available on our website.

We also consider the views of investors, which were relayed to us via the preliminary results of the Water UK Investor Survey. Water UK expects to publish a final report this month.

This document sets out our response to the issues raised that were relevant to the PR09 process and is issued in parallel with our final methodology paper, 'Setting price limits for 2010-15: Framework and approach'.

Fiona Pethick
Director of Corporate Affairs

1. Approach to the price review and executive summary

1.1 Purpose of this document

In this document, we set out our conclusions on the substantive issues raised in the responses to our October 2007 consultation on our proposed approach to setting water company price limits in 2009 for the 2010-15 period. For ease of reference we have retained the structure of the consultation paper and relate the issues raised to the sections in the paper.

For each issue identified in the consultation process we have summarised the points raised (without attributing them to individual responses) and provided an explanation of our views and conclusions. This approach means that we do not address points which are about regulatory issues beyond the price review process, or which concern matters of detail which are more appropriately addressed in the business planning process.

We have published the responses on our [website](#).

1.2 Key issues

In our consultation paper, we identified two key issues – competition and incentives. While the price review is not directly about the application of policies designed to fulfil our duties in respect of competition we wanted to signal to companies that we would continue working to develop the competitive markets alongside the price review process. We also highlighted our work to improve incentives, particularly in the business planning, revenue and capital expenditure areas.

In both areas we received a number of helpful and challenging comments.

1.2.1 Competition

Issue: Focus on competition will deflect from other issues

Consultation views

Two water companies and one stakeholder said that the focus on competition will deflect attention and focus from the real challenges such as flooding, and resilience. One company was unclear how competition will balance with sustainable development and highlighted the risk of uncontrolled competition leading to more risk of environmental deterioration and threat to water quality.

A water company said that Ofwat should take account of the impact of items such as the reduction of the threshold for competition and how this will work with the revenue cap. The reduction in the threshold was seen as increasing the revenue risk from non-households considerably. A water company said that a more competitive regime will increase business risk and was concerned that the current increased focus on competition rather than value will raise costs in the short term (higher cost of capital).

Our response:

Regulation of vertically integrated monopolies by means of comparative competition alone is not sufficient to deliver the best possible prices, incentives for innovation, quality and choice of services for users in the long run. A relatively static regime of regulation is likely to be subject to diminishing returns over time by comparison with the dynamic impact of competitive markets. In addition, for comparative competition to work effectively it needs a high level of certainty on the future number of comparators. The water industry now faces large challenges (climate change, security of supply, floods) and we believe competition is essential if we address these and contribute to the delivery of the Government's objectives for the water industry as a whole. For example, competition could:

- stimulate a more dynamic retail sector, providing better services to customers and helping to reduce water wastage;
- provide a greater focus by water companies on improving efficiency and reducing costs of supply (including leakage), making water more affordable;
- encourage more efficient allocation of water resources, reducing the potential impact of the water industry on the environment; and
- drive more innovation and dynamism in technology and processes, encouraging companies to find more efficient ways to abstract, treat and supply water, to help

to address the impact of climate change, reduce the carbon footprint of the industry and improve the quality of the environment.

Consequently, the promotion of competition is a key strand of our strategy. At the same time, we believe that effective regulation is essential, both where competition has not developed sufficiently to protect consumers, and for the enduring natural monopoly elements of the value chain. We will develop ongoing regulation and the competition regime in a complementary way.

Issue: Consumer buy-in to water competition

Consultation views

One stakeholder and a water company stated that there does not seem to be a desire for competition among consumers and that more work should be done on the areas which are most important to customers, that is, uninterrupted supply.

Our response:

In the absence of competition, consumers cannot demonstrate what they want and are prepared to pay for by choosing between alternative suppliers and alternative packages. Therefore, given the current monopoly structure of the sector, each company needs to understand what its consumers want and are prepared to pay for. We also need to understand consumers' priorities and preferences and take account of these in challenging the scope of each company's proposal. We are considering further interactions with customers specifically on their views on competition. Research shows that customers, business and domestic, do want choice in water – with 62% customers in England and 50% in Wales think the introduction of competition would be in their interest. ('Utility Week', 22 February 2008, page 20). The CCWater/Ofwat research of businesses found that 93% of business customers would switch for lower bills and 49% for better service.

Issue: CBA of competition, timescales

Consultation views

One water company stated that the costs and benefits of competition should be subject to a rigorous CBA test. Another stated that clarity is needed on any transitional arrangements (from the current monopoly regulation regime to the proposed arrangements) for competition. A stakeholder said that the timescale for introducing competition – which Ofwat has a duty to promote – is inordinately long.

Our response:

We will evaluate the potential benefits and costs of proposed changes to either the regulatory framework or industry structure before confirming these changes. The Government has announced its independent review of competition looking at all the necessary elements to ensure the regime delivers benefits for consumers and the wider economy. We welcome this. Our [proposals](#) to change the WSL regime (December paper 2007) and our forthcoming paper in spring 2008 on wider reform proposals are intended to contribute to the Government's review. We believe effective competition throughout the value chain requires changes to legislation; which will take time. However, we will work within the current statutory regime and to the limit of our powers to ensure that we promote competition wherever possible in advance of legislative changes.

Issue: Specific guidance on competition

Consultation views

Several water companies said that Ofwat should provide specific guidance and give examples as to how they should take competition into account in their business plan as there is uncertainty around the future direction of competition in the industry. One water company stated that it intends to prepare its business plan assuming that Ofwat's recently proposed modifications are not effective.

Our response:

Providing water and sewerage services is a long-term business. Companies must plan to adapt and amend their plans in the light of experience and new information. There is ongoing work with the Government's review of competition and our own work on the future of competition. We expect each company to set its own strategy and

business plan for the five-year period 2010-15 in a long-term context that takes into account the development of competition.

Each company must take account of our initiatives to promote competition in its business plan. It is possible that some of these initiatives will take effect during and immediately after this price review period. For example, under our review of competition there has been a positive response to our proposal to develop accounting separation. This would require each company to identify clearly and report separately on each key area of its business. This will aid transparency, improve cost reflectivity, identify competitive opportunity and make entry to the market simpler. While we will consult on this issue in more detail, it is likely that companies will be required to separate out for accounting purposes their notional retail business, their network business and their production and treatment businesses. We will also consider developing separate price caps for the various parts of the value chain.

Issue: Notified item for competition

Consultation views

A number of water companies said that unless there is sufficient clarity to incorporate into PR09 business plans the administrative costs of introducing competition, then a notified item is needed to ensure that those costs are recovered (that is, a new notified item for the costs of any customer transfer systems).

Our response:

We will consider the need for notified items as we set price limits in 2009. At that stage we will have a clearer view on the potential for material costs relating to preparations for a competitive market.

Issue: Innovation

Consultation views

Some respondents felt Ofwat should do more to encourage innovation, such as:

- allowing ring fenced expenditure for R&D;
- providing additional incentives; and
- clarifying our approach to risk relating to unproven technology.

Our response:

We accept that there is role for regulation to drive innovative approaches, for example reflected in new water efficiency targets or greenhouse gas accounting. In the medium term, we see a greater role for competition in driving and incentivising innovative approaches. Our approach to PR09 will facilitate this broad thrust towards more competitive outcomes.

We aim to promote innovation through the incentive framework we put in place, and the rewards we offer for outperformance and customer service. We will continue to offer enhanced incentives for the leading companies, through the capex incentive scheme and our approach to operating expenditure outperformance.

Our approach is generally arms-length and focused on outcomes, allowing companies freedom to innovate and take risks in how they deliver service to consumers and environment.

We agree that investment by the industry in research and development (R&D) and innovation is important. But we do not see the case for ring fenced expenditure allowances for R&D. Allocating specific expenditure to R&D, to be recovered upfront from customers, could mean companies pursue poor value schemes in order to spend an allocated amount, rather than focusing on delivering value. Our experience suggests that the leading companies are those that are willing to reinvest profits in innovative approaches, thereby maintaining their competitive advantage and ability to generate consistent outperformance. In addition, all companies will have R&D expenditure in base opex, and they have the full flexibility and opportunity to choose to innovate and spend in this area.

Issue: The incentive balance; package of risks and rewards

Consultation views

A number of respondents particularly the water companies have raised concerns about whether collectively the package of proposals presented in the October consultation paper changes the risk/reward balance for the sector. This includes a view that incentives have been diluted compared to previous reviews.

Some companies expressed concern that Ofwat's use of its fining powers had distorted the incentive balance such that there was now more emphasis on punishing failure rather than rewarding success and good service.

Our response:

The water industry remains fundamentally a low risk business. Our decision on the cost of capital will be taken in light of all of the evidence available at the time and we will consider the package of proposals in the round, including incentive mechanisms.

The exercise of enforcement powers does not present a new risk that should be factored into the cost of capital assessment. A compliant industry need not be concerned about enforcement action and it is something that companies can clearly influence and management can control. The cost of capital is set on the basis of an efficiently managed and financed company.

We do not believe that our use of the powers given to us by the Water Act 2003 have distorted the incentive balance. We think our approach has provided clarity and certainty – factors which will contribute to a less risky regulatory environment. At the same time, we have not reduced the rewards available for success – and the new arrangements for capital expenditure offer the chance of enhanced rewards for the best performing companies. Furthermore, we only use these powers when necessary.

Issue: Impact assessment

Consultation views

A small number of water companies said that Ofwat should have carried out a full regulatory impact assessment of the whole price review process

Our response:

The price review is not an optional process and we have not made any proposals for a route and branch review of our approach. Accordingly, we have not carried out a full regulatory impact assessment. However, we have considered the impact of changes to our regulatory approach under the better regulation principles (see chapter 7).

Issue: Independent review of PR04

Consultation views

A number of companies were concerned that Ofwat had not acted on the recommendations of the independent review of PR04.

Our response:

The independent review of PR04 made recommendations on how it thought we could improve our approach to setting price limits. We have acted on these – including consulting on our approach to financing networks, and working with the industry on a review of our approach to efficiency. We have also worked to reduce the information burden on the companies. Our new approach to capital expenditure incentives has the potential to offer a simplification of the information required from companies and we are requiring only one business plan.

2. The framework and process for setting price limits

2.1 The framework for setting price limits

Issue: Sustainability planning and financing

Consultation views

Companies said that initiatives on sustainability required long term planning and financing. Their view was that activities within this programme might need decoupling from the normal five-year blocks on a longer term, strategic basis. Some companies were concerned that Ofwat would not recognise customers' willingness to pay higher charges for an environment friendly agenda and that customers place a value on carbon reduction that is significantly greater than the shadow price of carbon.

Our response:

The PR09 process is set in the context of [strategic direction statements](#), which outline companies' priorities for the next 25 years. One of the aims of these statements is to promote forward thinking and planning beyond the five-year time horizon of the price review period. This will enable companies to plan effectively for tackling the long-term challenges of a changing climate and operate in a more sustainable manner. In addition, we have introduced the overlap programme; which enables companies to invest in more than one price review period and encourages a longer-term view on their activities.

We recognise that consumers value climate change and sustainability issues. One of the aims of utilising cost benefit analysis for investment decisions is to ensure that value for money solutions are delivered to consumers. The shadow price of carbon has been used as it offers a consistent basis for all companies and follows common government guidance. In many cases sustainability behaviours offer long-term cost efficiencies and should not require further incentives.

2.2 The process for setting price limits

Issue: A single infrastructure charge for each company

Consultation views

One respondent was concerned that our approach of setting a single infrastructure charge for all companies was unsustainable given the different circumstances across England and Wales.

Our response:

The purpose of the infrastructure charge is to pay for the average cost of improvements in the local infrastructure made necessary by the addition of new properties. We see no compelling reason for this to differ markedly across the country.

2.3 Risk and uncertainty

A concern running through many of the company consultation responses was that the proposed approach to PR09 had increased the level risk on each company, and that as we had not balanced this with new or improved incentives, we should make a more generous cost of capital assumption.

2.3.1 Notified items

Issue: Notified items for the 2010-15 period

Consultation views

Many respondents were concerned that Ofwat had in its consultation paper ruled out any notified items for the next price review period. Most respondents believed that we should retain some, if not all, of the five current notified items. One respondent argued that it was unlikely that we would need to retain any of the current notified items.

Our response:

Our methodology proposal was intended to make companies consider, from a blank sheet of paper, the need for notified items. We did not intend to signal that we would remove this important mechanism from our regulatory approach if it proved to be necessary.

It is clear from the responses to the consultation that companies still see a need for notified items – both in the existing areas, and in new areas where risk and uncertainty seem high. We are not expecting to make initial decisions on whether to include notified items and if so which ones, until we have considered proposals and arguments put forward in draft business plans (as we did for PR04). Accordingly, we expect companies to continue to develop their thinking in this area. Each company will have an opportunity to discuss its initial proposals with us in the forthcoming round of pre-draft business plan meetings.

2.4 Timetable

Issue: Incorporating late additions to price limits

Consultation views

A number of respondents were concerned that our proposed process was too inflexible to deal with new investment requirements decided after March 2008.

Our response:

We are clear that we can set the best price limits for customers where companies have full knowledge of what they need to deliver in good time to prepare their draft business plans for submission in August 2008. We think this means having knowledge by the end of March 2008. However, we recognise that such certainty may not exist in the real world and we have developed a process that is flexible enough to deal with later advice on investment requirements. Notwithstanding this, the best option for all stakeholders is for companies to know what is required of them in good time for this to be incorporated into a coherent plan for investment that sits clearly in the longer term context. After we have set price limits companies can use change protocol procedures to address the risks of having to make significant capital investment.

3. The right outcomes for consumers

3.1/3.2 Understanding consumers' preferences

Issue: Understanding consumers' preferences

Consultation views

There were some requests for more information on the three-stage approach set out in the consultation paper. Particular clarity was sought around the stage 3 timetable, the organisations involved and how the research would dovetail with the companies' own research completed at stage 1 and the joint stakeholder research at stage 2.

Our response:

The stage three research will be a joint stakeholder project involving Ofwat, CCWater, Water UK, Defra, Environment Agency, Natural England, DWI and Welsh Assembly Government. As for stage 2, the joint stakeholders will publish the results and research materials (in January 2009).

The stage three research will be the first opportunity to ask consumers for their views on the combined and costed package of outputs presented by each company in its draft business plan. The research will seek consumers' views on the value for money, acceptability and affordability of a company's plan. It will inform companies' final business plans and our decisions on draft and final determinations.

The research is intended to supplement the companies' own research and the deliberative work commissioned by the joint stakeholders group at stage 2 and to build on these. It will not repeat company work on individual schemes but analyse views on the overall plan and on programmes of work such as overall drinking water quality and maintenance of assets for example. The research will reflect the expected benefits and impact on consumers' bills of these programmes.

The research will produce results in December 2008 with statistically robust results for each company. However, the consistent approach will allow key results and messages to be drawn out for England and for Wales.

3.3 Sustainability

Sustainability rightly has a much higher profile for this price review. Many consultation responses urged us to take bold and decisive action to contribute to the solutions to the problems facing us. The water industry is more directly exposed to the impacts of climate change than most other industry because the availability of its raw material is sensitive to changing climatic conditions. This has good and bad consequences – on the good side, companies are used to addressing the type of problems that may become more common, but conversely, customers and companies will feel the direct impact of the uncertainty.

3.3.1 Climate change adaptation

Issue: Consistent approach to climate change

Consultation views

Many respondents expressed their concerns over our approach to climate change. They have highlighted the importance of engaging all parties at an early stage to ensure a common basis of assessment and consistent approach for carbon calculation and reporting. They advocated a more coherent strategy and approach between regulators, the importance of strong sectoral working, approach to integration and coordination of adaptation responses to climate change. Some respondents were unclear about engagement of industry with stakeholders on climate change.

Our response:

Our draft approach provided common approaches towards climate change mitigation and adaptation. Including the shadow price of carbon in CBA will ensure that the impact of emissions, both now and in the future, will influence investment decisions. The CBA will act to justify investments which contain significant adaptation components through the inclusion of social and environmental costs. Further comments on adaptation and resilience are addressed in section 3.7 on “resilience”.

We have been engaged with the wider industry, through interaction with UKWIR and others, in a number of key climate change related issues. These include a common methodology for carbon accounting, the formation of an adaptation tool and the development of a research strategy. We will continue to work in collaboration with the water industry to promote consistency in this evolving and developing area.

3.3.2 Carbon impacts and management

Issue: Renewable energy generation

Consultation views

Companies and NGOs are saying that where customers are willing to pay, they should be allowed to finance the cost of any renewable energy scheme from within the regulated business. Companies are looking for price limits to fund the mandatory reductions in carbon emissions, through the generation of renewable energy, and argue that some activities will require Ofwat to allow costs at PR09.

Our response:

The consultation paper outlined our position on renewable energy generation. In response to queries and feedback we have refined the text in section 3.3.2 to clarify a number of points. In addition, we will be issuing guidance in June which will further clarify our approach on renewable energy generation.

Companies are free to invest in development of renewable energy generation and play a part in the separate competitive electricity market. Only where the energy source is linked to how companies provide water or sewerage services – such as combined heat and power at sewage treatment works – should it be part of the regulated business.

3.3.3 Indicators

Issue: Climate change scenarios

Consultation views

There appeared some confusion among respondents over what scenarios should be used in the preparation of business plans. Some companies think there is insufficient time to incorporate new scenarios from UKCIP08 into this price review.

Our response:

We expect companies to base any climate change related investments on the best available sound science. This follows the Government's principles of sustainable

development. In addition this provides consumers additional reassurance that sensible and appropriate decisions are being made in this important area.

UKCIP08 is due for release in November and will provide an updated set of climate predictions which are specifically tailored for the United Kingdom. This will replace UKCIP02 which has commonly been used by the water industry as the standard for climate prediction information. UKCIP08 will present data in a different way from UKCIP02, with a much greater emphasis placed on a probabilistic interpretation of data. Although the presentation of data will change, it is expected that the underlying climate change messages will not significantly alter.

We acknowledge that it will be difficult for a full analysis of UKCIP08 data to be incorporated into business plans. However, we expect companies to have carried out sufficient climate change sensitivity analysis on investment decisions to be able to identify which projects are likely to be significantly affected by a change of input data. In the context of a CBA this means that projects which may move from being cost beneficial due to a change of climate input data should be flagged and possibly re-tested using UKCIP08.

Issue: Further development of carbon management and sustainability

Consultation views

It is thought that carbon targets need greater definition at company level and that there should be further guidance on sustainable development. Ofwat should provide clear guidance in relation to carbon management and climate change adaptation.

Our response:

Companies are required to participate in the Carbon Reduction Commitment (CRC) scheme and we do not intend to introduce another overlapping carbon management scheme. However, we are considering how to address the issue of the gap in greenhouse gas (GHG) emissions not covered by the CRC and text has been added to section 3.3 of the March paper to reflect this.

Sustainability is an integral part of a low-carbon future. We expect companies to embed sustainable behaviours in all their activities. In many cases sustainable solutions will be contained within investment options which are subject to CBA. In other cases sustainability behaviours will be integrated within wider company policy and sit outside of the PR09 process.

Our broad approach to sustainable development is set out in MD219, ‘A sustainable water industry – To PR09 and beyond’. The UK Government has also provided guidance through the Sustainable Development Commission and other measures. In addition, the water industry is voluntarily reporting against a basket of sustainability measures. It is not our present intention to produce further guidance which duplicates information which is currently available. We expect each company to take ownership of its sustainability plan.

3.4 Justifying proposals for service and investment

3.4.1 Cost Benefit Analysis methodology

Issue: CBA – validity of using CBA for all schemes

Consultation views

Some companies expressed concern about the application of CBA to certain schemes, such as health and safety, resilience, water quality and some categories of maintenance activity (for example, management and general). They were also unclear on Ofwat’s exact requirements for CBA.

Our response:

CBA should be applied universally across the business plan. We believe performing CBA across the whole programme is part of good governance and better regulation as it enables both transparency to consumers and accountability of companies and regulators. It enables customers to be informed and understand the value of investments paid for through bills.

Where a company has concerns about its ability to assess accurately the benefits of investments additional evidence should be provided to explain, and justify, its plans. CBA is ‘best practice’ and, as such, should be used for all business-as-usual investment decisions. For many companies this can be achieved for base service, including management and general, through a proper application of the capital maintenance common framework, and for supply/demand through the economics of balancing supply and demand approach. These approaches allow companies to identify and justify the most cost beneficial set of interventions.

Where a company feels a scheme is important but the costs outweigh the benefits when subjected to CBA, the company should look at ways of improving the scheme

through innovation or changing the timescale and/or scope of the investment. This may reduce costs or increase benefits that fall outside its primary purpose.

Issue: CBA – necessity of using CBA for schemes with statutory drivers

Consultation views

The consultation exposed differences in opinion over the application of CBA (and carbon accounting) on schemes with statutory drivers. Some respondents felt this should have been done by the standard setter at the time of the policy decision, therefore is not for the company to do now. However, others felt that it is worthwhile and it is essential that companies can show what is best for consumers without the restrictions imposed by mandatory requirements.

Our response:

CBA is first and foremost a decision making tool for the companies to use as they develop an optimal business plan, irrespective of the legal standing of a given outcome. In some cases there may be only a very small range of options to deliver a statutory outcome but the application of CBA will still be worthwhile as it will contribute to the need to be transparent and accountable and may contribute to innovation.

It is conceivable that CBA may highlight that some statutory outcomes seem to offer low value for money. While this cannot be a reason for a company not delivering the best solution in accordance with the legal requirements, it may prompt further consideration of the scope of required investment.

Assessing all schemes, including those whose driver is mandatory requirements, gives the ability to assess how greater benefits can be achieved to consumers, society and the environment through prioritisation and or adjustment the scope of investment. It also allows 'local' and 'global' issues to be balanced so that sustainability and climate change impacts can be assessed alongside the local quality improvements associated with the statutory requirements. This is essential for identifying the optimal mix of investment for consumers, society and the environment over the long term and has been identified by many as a welcome addition to our price review requirements.

Issue: Shadow price of carbon

Consultation views

The majority of respondents welcomed our proposal that sustainability and climate change impacts, including the shadow price of carbon (SPC), should be considered in a company's CBA. However, there were concerns that:

- more sustainable investment may not be shown to be worthwhile on cost-benefit grounds; and
- the proposal of a carbon reduction target by Ofwat might be incompatible with the inclusion of the SPC in a company's CBA.

Our response:

We are encouraged by the positive feedback received regarding our proposals for the inclusion of sustainability and climate change impacts in a company's CBA. This is a developing area and we are working with the industry and other regulators to ensure it is tackled as best as we can at PR09. Although we are pleased by the positive stance being taken by the industry and regulators and the desire to tackle the problems associated with climate change, it is important that CBA considers all other factors as well. The effect of including the SPC in CBA is to factor in carbon impacts alongside other issues. It is not to be taken in isolation from other costs and benefits.

We will continue to encourage companies to seek ways to reduce carbon emissions. However, we will only include investments to reduce carbon emissions targets where there is evidence that these are justified on cost benefit grounds, and properly form part of the regulated business.

Issue: CBA – no single generic methodology

Consultation views

A few respondents raised some concern that companies are using different methodologies for their CBA instead of one generic methodology, with some companies worried that Ofwat will compare one company's CBA with another as opposed to taking a pragmatic view that appreciates that CBA at PR09 is a new requirement and all companies are on a learning curve. Some companies are also concerned that their analysis may not address all aspects covered in PR09/08: 'Further Ofwat guidance on the use of cost benefit analysis for PR09' as they had already started their work prior to its release.

Our response:

As the respondents acknowledge we are all on a learning curve in applying CBA at PR09. As such we believe it would be inappropriate to require all companies to use the precisely the same methodology as they each have their own specific strategies and set of circumstances in which they operate. An important development at PR09 is our encouraging each company to take greater 'ownership' of its business plan. Prescribing one methodology that should be followed rigidly by every company would be counter to this development.

That said, we do recognise that some commonality is required across the different methodologies. As well as our consultation paper, we released further guidance on the use of CBA for PR09 ([PR09/08](#)). This references other relevant reports, primarily those commissioned by UKWIR, that give guidance on the application of CBA. These documents will ensure the required consistency of approach and assumptions across companies.

Because this is a new area, we are also requiring each company to get its work peer-reviewed to assess the reliability of the results. This should help both the companies and us to make appropriate use of the results and supporting evidence. At present, we are not proposing to undertake a mechanistic comparison of companies' submissions. However, we will carry out an appropriate review of submissions to ascertain the quality and reliability of results, both with regard to the benefits assessments and the inclusion of these in CBA. The regional nature of the consumer surveys will demonstrate differences in valuations of similar impacts across companies.

Issue: Additional draft business plans

Consultation views

Some respondents expressed a number of concerns about the requirement for additional plans. They were unsure:

- of the exact circumstances in which an additional plan should be submitted;
- about the timescale for deciding whether an additional plan would be required and when the additional plan should be submitted; and
- who would make the decision as to whether they needed to submit an additional plan.

Our response:

In the consultation, we set out the criteria that a company's plan should meet:

- is consistent with its SDS;
- is owned by the company;
- puts in place a package of outputs which will deliver specified statutory outcomes;
- is in line with consumer priorities for service levels and bills;
- optimises and exposes the costs and benefits of the plan at the overall and component level; and
- has no need for any specific financeability adjustment.

If a company's draft plan cannot meet these criteria then the company should submit an additional plan. This plan should offer improved investment proposals through innovation or by changing the timescale and/or scope of outputs.

There is no set timetable for deciding whether a company will need to submit an additional plan, but any additional plan would need to be submitted alongside the primary draft business plan by 11 August 2008. Where a company is unsure whether it should submit an additional plan it should discuss the matter with us.

Issue: CBA – treatment of CBA results

Consultation views

A few respondents expressed concern that Ofwat will use the results of CBA mechanistically. The results from CBA may not always reflect what consumers actually want. To minimise conflict it was suggested that CBA evidence should not be the only driver for determining investment proposals.

Our response:

We state in PR09/08 that companies should not use the results mechanistically when deciding on their investment proposals and should consider any additional evidence that is available. There is likely to be uncertainty surrounding both the impacts of schemes as well as monetary valuations and we expect a company to take this into account when deciding upon its investment programme. Where a company believes there is evidence that some outcomes from its CBA are not in line with what their consumers want then it should take particular care in explaining clearly the decision behind its proposals in its business plan. This could involve, for example, the possible exclusion of investment with a positive net present value (NPV) or inclusion of those with a negative NPV.

Issue: CBA – treatment of equity and distributional issues

Consultation views

Some responses revealed a lack of clarity regarding how a company should tackle equity and distributional issues and a possible need for additional guidance in these areas.

Our response:

We believe that one of the advantages of CBA is that it allows a company to identify any equity and/or distributional issues that may arise. We will expect each company to use information around the distribution of benefits, for example across socio-economic groups, to build up its investment plan and it should be able to explain and justify how it has taken account of these issues.

We expect companies to discuss how they propose to address these issues with key stakeholders such as CCWater and welcome further dialogue with companies to aid our understanding of their various approaches.

Issue: CBA – measuring environmental impacts

Consultation views

Some respondents felt it is inappropriate or impossible to quantify environmental benefits and often hard to judge the impact of schemes. Responses exposed a desire for qualitative as well as quantitative descriptions of impacts to be included in business plan submissions.

Our response:

Prioritising and concentrating investment on areas of most value will help deliver greater benefit to the environment over the long term. Without placing a monetary value on environmental impacts, it is not possible to assess them against other impacts, for example, drinking water quality, interruptions to supply or alternative environmental impacts.

There is likely to be uncertainty around the impacts of investment both for the environment and in other service areas. We expect each company to work with the relevant stakeholders to determine the potential impacts of its schemes.

We do not believe a scheme can truly be justified if the impacts of the associated investment are unknown. Placing equivalent monetary valuations on impacts is reliant on accurate assessments of the actual impacts of investment. It is therefore essential that a company identifies and values the planned impacts its investment proposals will have and provides its view of the reliability of these estimates.

Issue: CBA – reliance on economic analysis

Consultation views

There were concerns from some respondents that the methodology paper concentrates too much on economic analysis. A common view was that customer priorities as well as societal and environmental impacts should also be given due weight.

Our response:

We are pleased that there is significant support for ensuring that companies' investment programmes deliver what is best for consumers, society and the environment over the long term. And we do not see any conflict with our requirements for CBA. Indeed CBA is not simply concerned with the financial impacts of schemes but also considers the wider impacts of investment. Our requirement for a company to undertake consumer surveys to value service ensures its consumers' preferences are met.

Benefits assessments give valuations of the different impacts in a common measure, which allows direct comparison of costs and benefits of a scheme, as well as comparing the impacts of different schemes. This will allow effective prioritisation of investment in those areas that deliver greatest benefit relative to the costs. These benefits can be social and environmental as well as economic. Hence, the importance of valuing them all, so all can be assessed in an even-handed way.

Issue: Cost efficiency analysis – least cost planning

Consultation views

A few respondents expressed concern that we are not requiring companies to use cost efficiency analysis/least cost planning in determining their optimal investment programme.

Our response:

Our requirements for CBA at PR09 clearly state that a company must still perform least cost planning in deriving its optimal investment programme. In PR09/08 we state that each company must follow a two-step process to undertake the appraisal of its investment proposals as it builds a coherent and economically efficient draft business plan. It must:

- use least cost planning to identify the most efficient mix of inputs to produce different levels of output/service provision (that is, the supply curve). This supply curve represents the mix of inputs that minimises the cost of producing each level of output (that is, “productive efficiency”); and
- use CBA to determine the economic level of output/service provision (that is, identify the point of “allocative efficiency”).

Issue: CBA – benefits assessments

Consultation views

A few respondents raised questions about how companies should use the results from single-issue studies. One company was also concerned about the reliability of using benefits transfer.

Our response:

We recognise the issues associated with benefits transfer and expect companies to maximise the use of their own consumer surveys in assessing the majority of benefit valuations. However, this is not the only source of values and we also expect companies to make justified use of additional values where necessary. Where appropriate, a company may wish to transfer values from other studies, if it can demonstrate that these values are relevant to its consumers and the impacts being considered are comparable to those assessed in the original piece of work.

The use of surveys other than the company's own work is an area where caution should be exercised. Single-issue surveys are known to over-estimate benefits as respondents do not consider the issue in the context of other service areas or impacts on their bills. Countrywide studies may give good valuations of the values placed upon impacts nationally but may not give reliable valuations at a local or even regional level. These values cannot, therefore, be said to be necessarily representative of a water company's consumers. It is important, therefore, that the results of any study are used in the context of what was being valued and should not generally be used outside this context.

3.5 Base service outcomes – maintaining service

Issue: Serviceability assessments

Consultation views

There were views that:

- serviceability assessments were opaque, subjective and lacked rigour. It was essential that the assessments are clear and transparent and genuinely reflected the likely trend in future service to consumers;
- assessments should reflect the economic level of the indicators, such as an economic level of bursts; and
- we placed too much reliance on individual indicators, some of which were too detailed. Some indicators were inappropriate and remote from service delivery to customers.

Our response:

We are committed to being open and transparent, our approach was set out in information note 35 in January 1997 and since then we have fully engaged the water companies, most recently in the joint review of serviceability indicators through UKWIR in 2006. We provide updates to regulatory directors (for example, [RD15/02](#) and [RD15/06](#)) and we publish and provide commentary on serviceability assessments annually in our 'Financial performance and expenditure' report. Our assessments are based on trends in objective asset performance and service indicators. Understanding the implications of trends in particular indicators requires expert judgement by us, supported by external quality assurance, details of which we will publish in future years.

We recognise there is some scope for continual development of indicators. For example, we have recently introduced sewer blockage monitoring, a principal cause of sewerage service loss. We are proposing a hydraulic overload indicator for flooding from sewers that excludes severe weather events, which is a closer measure of whether the sewerage system is fit for purpose and, because each company is sufficiently funded for dealing with growth from existing and new customers we expect this indicator to be held stable.

We agree with the need to achieve an economic level for each of the indicators. It is for companies to make the case for the economic level, using appropriate CBA. But without clear evidence we will expect companies to maintain stability in serviceability.

3.6 Security of supply

3.6.1 Water resources

There were no material or general comments in this area.

3.6.2 Security of supply index (SoSI)

Issue: Supply/demand defined outputs

Consultation views

One respondent suggested that the security of supply index (SOSI) does not provide a robust basis for defining supply/demand outputs because it is sensitive to changes in assumptions about deployable output and outage. Other respondents expressed concern that Ofwat might not be taking a balanced approach to logging up and logging down.

Our response:

We recognise that the SOSI is sensitive to changes in assumptions about deployable output and outage, and that it might be appropriate to make such changes in the light of new information. We will continue to take a pragmatic approach to such matters, recognising that we should assess companies' performance on the basis of factors that are within management control.

[PR09/06](#) set out our approach to logging down at PR09. Our policy on logging up remains as set out for PR04.

3.6.3 Leakage

Issue: Leakage

Consultation views

A few respondents commented on leakage. Some noted a potential conflict between adhering to the economic level of leakage (ELL), which is the basis for current leakage targets, and reflecting customers' willingness to pay for lower levels of leakage. One company argued against any changes before PR09 to the methodology for setting leakage targets.

Our response:

We think that companies' ELL calculations should take account of all the costs and benefits of leakage control, including the value of customers' preferences. In this way, customers' preferences should determine the ELL itself, rather than indicate that leakage should be above or below ELL. Companies must be able to demonstrate that their evidence on willingness to pay is robust. In particular, they should make sure that customers understand the long-term effect of their preferences on their bills.

We will seek to implement improvements to the methodology for setting leakage targets if the changes are feasible. Water companies are represented on the steering group for the joint Ofwat/Environment Agency review of the methodology for setting leakage targets, so we will be well aware of companies' concerns about timing and feasibility.

3.6.4 Metering

There were no material or general comments in this area.

3.6.5 Water efficiency: the role of economic demand management

There were no material or general comments in this area.

3.6.7 Growth and new development

Issue: New development costs

Consultation views

A few respondents suggested that Ofwat should review its approach to recovering the costs of new development. Two respondents suggested that we should review our policy on infrastructure charges, making them more cost-reflective. Others suggested that we clarify the rules on recovering the costs of new development.

Our response:

We consider that the existing framework for charges is sufficiently established and, while there might be room for improvement, it remains fit for purpose. We therefore plan to review our policy on this issue after PR09.

3.7 Resilience and flood risk

Issue: Resilience

Consultation views

There were some comments that Ofwat's treatment of the resilience issue was too narrow and did not consider other events such as coastal flooding, drought and terrorism attacks, fire and loss of power. Some were unclear over the adoption of a consistent methodology for assessing resilience proposals.

Our response:

Our consultation paper specifically highlighted the risk from flooding, but we do not intend for companies to consider flooding as the only hazard. However, many of the risks mentioned have not changed since we last set price limits. Furthermore, a responsible company would act to deal with risks when these became significant and would not wait for a price review before taking action.

We expect companies to understand the criticality of their infrastructure and the risks from a full range of hazards under current and changing climate conditions. Any further capital investment to increase resilience and adapting to climate change will be subject to CBA, as highlighted in the consultation paper.

We are currently working on the production of a framework which will allow companies to assess the criticality of their infrastructure and respond to the threat posed by flooding both now and in the future. This work will act to ensure that a common and transparent approach is taken throughout the water industry. This project is being carried out as part of our wider response to the Pitt Review. We also expect companies to respond to wider SEMD (Security and Emergency Direction Measures) requirements and to take responsibility for their operations by having full business continuity plans and measures in place.

3.8 Setting the scope of the quality programme

3.8.1 The scope of the quality programme

There were no material or general comments in this area.

3.8.2 The Water Framework Directive

Issue: Catchment management

Consultation views

Nearly half the responses addressed this issue directly or indirectly. Some broadly accepted our position or argued for a tougher line to ensure the Polluter Pays Principle (PPP) is upheld, but most argued for a more pragmatic and less restrictive approach, relaxing in particular the requirement for the company to own the land or for the investment to relate to meeting a defined legal requirement.

There was general concern that the approach set out in the consultation paper was too restrictive.

Our response:

We have actively developed the themes raised in the consultation responses and have provided a detailed explanation of our final approach in the final methodology paper.

3.8.3 Improvements to drinking water quality obligations

There were no material or general comments in this area.

3.9 Sewer flooding

3.9.1 Sewer flooding enhancements

Issue: Sewer flooding

Consultation views

The following three key themes were raised by several respondents:

- Use of sustainable urban drainage and surface water management.
- Problems where a cost beneficial permanent capital solution may not be available.
- Properties with mitigation remain on the 'at risk' registers.

Our response:

A number of respondents were keen to see more use of sustainable urban drainage solutions and integrated urban drainage to reduce the load on the sewers, and the future potential for sewer flooding. We expect companies to propose plans that optimise the management of the sewer network. This may include more use of surface water management, and working on upstream approaches with developers and others to manage the demands being placed on the sewer network. Companies should take account of forthcoming Defra guidance on integrated urban drainage management. We will expect companies to contain sewer flooding risks as part of base service.

One respondent suggested that solutions should be provided for all properties up to a certain level of protection (for example, a 1 in10 risk), regardless of cost benefit considerations. Our view is that companies should carry out cost benefit analysis to identify investments which deliver most value to customers. We expect companies to prioritise the sewer flooding programme in accordance with the views of their customers. Where properties are at risk of flooding, but no cost beneficial capital solution is available, we will expect companies to engage pro-actively with consumers to identify acceptable mitigation solutions.

It is possible that some properties will remain on the sewer flooding 'at risk registers' where mitigation is used instead of a capital solution. This risk will be detailed in a Home Information Pack when the owner wishes to sell the property. CCWater suggested creating a separate register for properties that benefit from a mitigation solution. We will consider this proposal, when we have reviewed companies draft business plans. In principle we agree that there is a need to promote a more creative approach to mitigation programmes.

3.10 Other service enhancements

There were no material or general comments in this area.

4. Understanding the costs of delivery

4.1 Approach to delivery costs when setting price limits

There were no material or general comments in this area.

4.2 Reviewing the 2004 approach to costs and future efficiency

Issue – Capital estimating scorecard

Consultation views

The following four key themes were raised by several respondents:

- The scorecard appears to be a significant burden on companies.
- The approach is intrusive and not in keeping with hands off regulation.
- There has been a lack of transparency and consultation with the industry.
- More clarity is needed to explain the use and benefit of the scorecard in setting price limits and how it interacts with other tools.

Our response:

Completion of the scorecard should not be excessively burdensome. The aim is to expose the maturity of the estimates of the largest 20 or so schemes (by value), not necessarily to ensure that all schemes are developed to the most mature stage. We will review and update the reporting threshold so that the scorecard is applied to approximately 20 schemes for each service to get a small representative sample.

The intention is for the scorecard to be applicable to any procurement model and we expect all companies to be able to complete the assessment irrespective of the source of the estimate.

We are committed to being open and transparent and we have provided updates throughout our PR09 development work. The issues relating to the robustness of capital estimates were raised in [RD17/06](#) and [PR09/01](#), there have also been three industry events which provided opportunities for discussion and feedback on the development work as well as regular updates at reporter workshops.

The proposed scorecard is one of several tools we intend to use:

- To create a better understanding of the risk and opportunities embedded within business plan estimates.
- To provide a window into how the strategic policies and approaches, as set out in the business plan commentary, work at project specific level.
- To provide insight into the achievability of the forecast investment profiles (for example, a project which scores zero for scope definition that is planned to be constructed in year 1 would be challenged).

The sample size is small to limit the burden on companies and reporters and because we recognise that the estimating technique should be appropriate to the materiality of the investment. We intend to use the scorecard to prioritise our analysis and support any challenges. We understand that there may be valid reasons why projects may score of zero or one in some or all of the criteria. Companies are required to provide commentary to explain the scores and whether the assessments reflect the typical level of robustness of their programme.

There are several benefits gained by introducing this tool, notably it provides:

- The ability to respond to criticism about high outperformance and conservative business plan estimates.
- A more structured, informed and consistent approach to challenging capital estimates.
- Companies with an opportunity to demonstrate transparency (to us and their reporters) between its high level approaches to forecasting capital expenditure and its approach at a project (or group of projects) level.
- A framework to assist reporters understanding and challenge of capital estimates.

4.3 Approach for the 2009 price review

There were no material or general comments in this area.

4.4 Menu regulation: our preferred approach for capital expenditure

Issue: Menu regulation (PR09/02) (now known as the Capex Incentive Scheme – CIS)

Consultation views

- Companies wanted to understand better how the baseline will be set.
- Some companies did not think that the proposal offers them a genuine choice:
 - Specifically relating to cashflow and financeability; and
 - Some disagree that the proposals result in a lower cost of capital.
- Some companies felt that the incentives were weaker than the PR04 approach.
- Stakeholders could not see how the proposal provides notable simplification.
- Companies and stakeholders raised concerns about timing and achievability.

Our response:

We have updated our methodology to provide further clarification on our approach to setting the baseline. Specific responses to the three main areas raised in the consultation responses include:

- The baseline will be linked to outputs and adjusted throughout the price setting process to reflect changes in requirements. Following the price review the change protocol will continue to be the method for dealing with changes in circumstances.
- The common framework principles of sound asset management planning are central to our assessment of capital maintenance requirements. The comment about simplification in the consultation paper related to our assessment process. We expect companies' business plans to be built up using high quality, intellectually rigorous asset management processes.
- The cost base challenge will be consistent with the concept of a central estimate and will be based on comparison against the costs that can be expected from a middle ranking company and not the frontier.

We are committed to ensuring that the baseline represents a central estimate (efficiency assumptions, reasonable and central approach to risk and well evidenced outputs). We expect company business plans to be distributed either side of the baseline. This is a key difference between our approach and the one adopted by Ofgem. Respondents may not have been fully aware of this difference in comparing the incentives proposed in the draft incentive matrix published in [PR09/02](#), with those offered by Ofgem in the gas or electricity distribution price reviews.

We have listened to respondents' views and agree that the incentive regime cannot easily provide incentives for both robust business planning and offer a choice for risk/reward tradeoffs. We consider the key benefit of adopting a new approach is to improve the incentives for realistic, high quality business plans.

We note concerns about the possible cash flow and financeability implications and will consider them as we develop detailed proposals for the delivery and timing of incentive rewards and penalties.

We intend to maintain incentives for all companies, particularly those at the leading edge, to drive efficiency improvements. We will take this into account in developing the detailed structure of the incentive matrix to be published in December.

We acknowledge that the simplification benefits for PR09 will be comparatively modest, though not insignificant (for example, the retirement of capital maintenance econometrics). In future price reviews the adoption of new incentive-based approaches may allow for further reduction of the regulatory burden.

We have noted concerns about transparency in terms of publishing (what, when and explaining changes) and have included details of how we will handle this through the price review process.

Several issues were raised concerning the amount of detail yet to be clarified and how that relates to the submission date of the draft business plans. We have provided further clarity on our approach (particularly on how the baseline will be set). We believe companies and stakeholders now have sufficient information on our approach and intentions to inform their approaches to draft business plans. As set out in the October paper section 4.2.4 we will publish further details in December 2008.

4.5 Evolution of the PR04 approach

4.5.1 Operating expenditure

Issue: Energy costs

Consultation views

Water companies were the only respondents in this area. They were concerned that Ofwat had not addressed the issue of rising energy prices in the consultation paper as energy costs form a significant proportion of industry operating costs. Some companies suggested that energy costs should be indexed to movements in energy prices or another retrospective correction mechanism should be used. A notified item for energy costs was also suggested by one respondent.

Our response:

It is too early to say whether we will need to make an additional allowance for energy costs above that included in companies' base operating costs. We expect companies to continue to develop their thinking in this area. Each company will have the opportunity to discuss future energy costs in the forthcoming round of pre-draft business plan meetings.

4.5.2 Pensions

Issue: Pensions

Consultation views

This issue was only raised by water companies. Respondents asked for further clarification on whether the allowances made by Ofwat for deficit funding at PR04 would be continued, and on what basis we will assess the required deficit funding. Respondents were also concerned how our methodology for pensions would take account of the accounting treatment of pensions under FRS17. Other issues raised were the changes to pension regulation and how we would deal with changes to companies approach to pension risk.

Our response:

We do not think that we will need to revisit the adjustments made at PR04 to deal with pension deficits and future contributions. We expect that the pension costs included in

the base year will include deficit funding. We will use this as a basis for setting prices going forward. We will ensure that when we set prices we take account of the accounting treatment of pensions under FRS17, so that we make allowance for the total cost of pensions.

4.5.3 Future operating expenditure efficiency

Issue: Future operating expenditure efficiency

Consultation views

The majority of responses were from water companies. Respondents were concerned about Ofwat's belief that the industry could continue to outperform the UK economy. Respondents believed that efficiency gains are becoming harder to achieve, and it is unrealistic to expect the 'privatisation effect' to continue. Some respondents believed that it would no longer be appropriate for Ofwat to set a continuing efficiency target. In looking at the scope for future efficiency, respondents were also concerned that Ofwat should take account of the impact of rising input prices.

Some companies said that we were wrong to apply efficiency targets to all costs and that we should only apply them to 'controllable' costs.

Our response:

We will commission a study on the scope for future efficiency in the spring of 2008. We will use the results from this study to inform our decisions on the scope for future efficiency.

We will apply robust and realistic efficiency assumptions to all operating costs. The issue of controllable and non-controllable costs has been raised many times in the past. Our relative efficiency analysis takes account of both of these costs to produce a weighted answer.

4.5.4 Operating expenditure efficiency analysis

Issue: Operating expenditure efficiency analysis

Consultation views

Respondents generally welcomed our proposal to evolve the approach to operating expenditure efficiency analysis used at PR04. Some respondents were concerned about the statistical robustness of our econometric models. We were also asked to clarify our approach to special factors.

Our response:

The concerns about the robustness of our econometric models are not new. We are working with the industry to review and update the econometric models. Our expert adviser, Professor Mark Stewart, also scrutinises our techniques and practices annually.

We are currently reviewing the special factor process and will set out our approach to the use of special factors for PR09 in spring 2008.

4.5.5 Assessing capital expenditure

There were no material or general comments in this area.

4.5.6 Capital maintenance expenditure

There were no material or general comments in this area.

4.5.7 Capital maintenance econometrics

There were no material or general comments in this area.

4.5.8 Capital enhancement expenditure

There were no material or general comments in this area.

4.5.9 Cost base

Issue: cost base

Consultation views

One water company expressed concern about the emphasis on new non-infrastructure schemes in the cost base, when most actual expenditure is on maintenance. Another water company felt that too much weight was put on the Cost Base at PR04. While recognising the efforts Ofwat has made, they still believe the majority of the differences between companies will arise from differences of interpretation of the guidelines, rather than true differences in efficiency. This will be exacerbated by the requirement to submit standard costs in areas where expenditure is greater than 2%, even where the company has no representative historic projects in this area. The company wants Ofwat to commission a study into the extent to which cost base differences are likely to represent differences in efficiency.

Our response:

At PR09 we will use the cost base to challenge the pricing of forecast expenditure. We will adjust expenditure forecasts to an achievable level of efficiency for a middle ranking company; this reduces the risk of choosing an unrepresentative cost.

Since PR04, we have added standard costs for maintenance work at water and sewage treatment works and removed some of the standard costs for new plant, to achieve a better balance.

We have introduced the cost breakdown structure, which will help detect and correct differences in interpretation. We now only require standard costs to be submitted where significant expenditure is planned, and these plans should be based on sound estimates of costs. If this is a new area of expenditure for the company and there are no representative historic projects, other sources of information, such as quotations from suppliers, may have to be used.

4.5.10 Managing investment cycles

Issue: Managing investment cycles

Consultation views

Responses to the proposals for an overlap programme between AMP5 (asset management plan) and AMP6 were generally supportive, but some potential problems were noted. These include the difficulties in having good enough cost information about proposals to be completed in seven years' time, and possible issues for companies that tender out or arrange frameworks for their whole AMP programme.

Some respondents were disappointed that the early start initiative had not been retained, and wished Ofwat to specify work for the AMP4/AMP5 overlap. Also, for the overlap into AMP6 one company wished this to be extended to maintenance as well as enhancement projects.

Our response:

At PR04, we tried to smooth the capital investment cycle by agreeing to approximately £1 billion of capital investment one year in advance of final determinations. As accepted by several of the respondents, this early start programme did not deliver the expected benefits of smoothing. In general, companies did not demonstrate a willingness to commit to and commence significant investment before the whole price limit package was confirmed. Companies and others have generally welcomed the new overlap proposals.

We believe that in the context of long-term planning companies should be able to identify and estimate costs sufficiently well to be able to design projects in AMP5 and complete construction early in AMP6, helping to smooth the investment cycle. If work is certain, companies can start the early stages of option appraisal and design in AMP5, and if necessary request that these costs be logged up or consolidated into the AMP6 year one costs of the project. In the relationship with contractors, it is for companies to manage the overlapping procurement contracts, not us.

We expect that companies' proposals for the overlap programme will be largely if not exclusively driven by enhancement schemes, but we recognise that some of the costs of such schemes could be allocated to maintenance.

The overlap programme may be appropriate, for some very 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 for generic maintenance requirements.

5. Financial assumptions for setting price limits

5.1 Setting the price limit revenue requirement

5.1.1 Capital charges

There were no material or general comments in this area.

5.1.2 Current cost depreciation

Issue: Current cost depreciation

Consultation views

Companies questioned the need to roll forward the whole period of comparison by five years instead of extending the period used at PR04 (1992-93 to 2019-20) to 2024-25, thus giving a 33-year period of comparison.

They argue that by increasing the period to 33 years the comparison would be made more robust.

Our response:

In theory, a calculation based on a 33-year period would be more robust, however there are issues with legacy data relating to pre-1998 assets, which many companies have realised in the past.

Many companies have inadequate data to be able to complete the table with actual figures for CCD charges on assets that are pre-1998. They have in the past relied on balancing figures and estimates in order to populate the table.

5.1.3 Overall check on the level of depreciation

There were no material or general comments in this area.

5.1.4 Asset life categories

There were no material or general comments in this area.

5.1.5 Infrastructure renewals charge (IRC)

Issue: Infrastructure renewals charge (IRC) - calculation period

Consultation views

Our proposed option of having a 15-year forward view has generated a mixed response.

Some companies suggest a 15-year forward view should be used for all companies.

Our response:

The alternative suggestions could allow companies to cherry-pick the years that would lead to highest IRC allowable. It would be difficult and time-consuming to assess the justifications given for the time period chosen by each company.

Few companies have a track record of demonstrating a long-term view of infrastructure renewals expenditure (IRE) when charging IRC in their regulatory accounts. Therefore, it would be difficult to assess a 15-year forward view for all companies.

5.1.6 Infrastructure renewal expenditure

There were no material or general comments in this area.

5.1.7 Prepayments and accruals

There were no material or general comments in this area.

5.1.8 Tax

Issue: Tax – group losses

Consultation views

One company strongly opposed this approach in principle because it has been introduced retrospectively.

Our response:

Many companies transfer losses for group tax planning purposes. Most companies obtain full payment for these losses but in 2005-06, one company was surrendering losses to group companies for less than full value. This is to the detriment of customers as the losses will not be able to be utilised in the future. Each company will have to justify its treatment of the transfer of losses.

5.2 Financing each company's functions

Issue: Our approach to setting the weighted average cost of capital (WACC) (sections 5.2.1 to 5.2.6 and 5.2.8 to 5.2.11)

Consultation views

Respondents raised issues relating to our approach to setting the cost of capital that cover and link a number of the elements set out in our consultation paper. These include:

- concern that it is premature for us to take the view that the WACC we assume for PR09 could be lower than that assumed at PR04;
- requests that we set out a timetable for how information used for setting the cost of capital will be shared;
- concern whether we will accurately reflect the net impact of a number of our policy evolutions on the overall risk faced by the companies;
- a lack of confidence in the CAPM model for estimating the WACC, with particular concern over the accuracy of equity betas;
- concerns that our assumption would be unduly influenced by recent acquisitions at significant premiums to the regulatory capital value and that we will use shorter-term evidence;
- views on whether we should allow for embedded debt were mixed and subject to the cost of debt we might assume in our WACC calculation;
- concern that a relatively aggressive gearing assumption, coupled with a floor on the level of gearing for calculating allowable tax, takes away companies choice of capital structure; and
- a mix of views was expressed over whether the claw back of the tax benefits of gearing up during the price control period was appropriate.

Our response:

For this review, we will set the cost of capital reflecting the up-to-date market data (but not by mechanistically observing spot rates). We will continue to recognise that the industry may have raised finance efficiently at a different part of the interest rate cycle and that a company raises finance over periods longer than the price control period.

There is currently significant volatility in the debt markets and very recently debt premiums have increased significantly. However, the risk-free rates for short, medium and long-term debt are much lower than when we set prices in 2004. In combination, the medium and long-term risk free rate and debt premiums remain below our PR04 assumptions, with long-term interest rates significantly lower.

We will continue to observe the transaction prices paid for any water company acquisitions and we will consider whether; the prices paid in recent transactions (and the evidence that it provides on the cost of equity) might arise from a short-term 'infrastructure bubble'; or indicate a longer-term downward adjustment in the returns required by investors given the stable and mature regulatory framework.

We recognise the inter-linkages between elements of the cost of capital and how our policy in one area might have implications for another. The capital markets are dynamic and at this stage it is too early to give definitive proposals for all aspects of our methodology for setting the WACC.

However, despite current volatility in the capital markets, the evidence suggests a lower cost of capital than the 2004 assumption.

We confirm the following:

- We will continue to use the overall CAPM framework but in recognition of its limitations we will continue to consider a wide range of market evidence and we will cross-check against other models.
- In arriving at our overall assessment we will link how we have considered risk in modelling costs and the risk-sharing mechanisms contained within the regime, including any change to our balance of risks and rewards arising from changes to our methodology.
- We will set a single cost of capital fixed for the five year period.
- We will set a notional level of gearing for all companies and we will consider the market evidence arising from the general upward trend in gearing for the sector when deciding on the appropriate gearing for this price review.
- We will allow for tax based on companies' actual level of gearing but with a floor equal to the level of gearing underpinning our assumption of the WACC. Our

expectation is that, in light of market developments, there will be very few companies materially below our gearing assumption. We do not consider our approach to tax unduly restricts a company's choice of capital structure.

We will set out with the draft determinations how we have reached our conclusions on the cost of capital. This will reflect the views of our financial advisors.

5.2.7 Indexing the cost of capital to a market benchmark

Issue: Indexing the cost of capital to a market benchmark

Consultation views

The vast majority of respondents, that expressed a view, rejected the concept of indexation. The reasons cited were common to many responses and are listed below.

- Companies are best placed to manage interest rate risk – not customers.
- Incentives are weakened – risk-averse companies will match the benchmark.
- Ofwat is not best placed to determine the appropriate benchmark for indexation.
- Proposals represent regulatory intrusion and are not justified by the potential adverse effects and complexity.
- Customers are likely to be exposed to rises in bills, triggered by the indexation mechanism, when prices generally are under pressure from rising inflation.
- Indexation to some extent double counts for inflation. Companies are therefore already protected by RPI-X.

Our response:

We have decided to reject this proposal and we will continue the approach whereby the allowed return on capital is fixed for the period of the price control.

Indexation of the cost of debt would transfer interest rate risk from companies to customers. We consider that this results in a sub-optimal allocation of risk without offering sufficient benefits to customers. In October 2007 the Competition Commission rejected indexation essentially on these grounds, arguing that the guiding principle in price control design should be that risk is allocated to the party that is best able to manage it. In February 2008, the Office of Rail Regulation also rejected indexation because it would introduce an additional layer of regulatory

complexity without clear compensating benefits. In addition to the above, we consider there are significant practical difficulties with identifying an appropriate index.

5.2.12 Small company premium

Issue: Small company premium

Consultation views

Respondents argued that:

- price impact costs affecting the cost of equity for smaller companies arise due to a lack of liquidity of smaller stocks and less liquid stocks are more susceptible to price impact because individual transactions are more noticeable;
- bid-ask spreads for trading equity shares remain higher for smaller companies;
- brokerage commissions are greater for smaller stocks, which are traded on different trading platforms to large companies;
- a large proportion of fees relating to both debt and equity issuance are fixed and transaction costs are therefore relatively more expensive for smaller companies;
- smaller companies are not guaranteed to access the debt markets via vehicles such as Artesian if credit wrapping not available; and
- removal of the small company premium would significantly increase financeability pressures.

Our response:

The allowance for the cost impact of illiquidity in the trading of water only company shares has historically been the biggest driver in the small company premium. Higher interest rates on debt and transaction costs relating to both debt and equity are much less significant drivers of the overall size of the small company premium.

For this price review we will put the onus on companies to provide evidence to support a small company premium. In particular we will require compelling evidence of how the impact of illiquidity in the trading of the equity in smaller companies continues to be relevant as all but Dee Valley Water are now unlisted or are listed as part of much larger groups.

5.3 Financeability

Issue: Financeability

Consultation views

It is too early to rule out any revenue uplift adjustments (although there was a general consensus that they should be NPV neutral), especially with the expectation of a large capital programme and a lower cost of capital.

Respondents generally agreed that it is appropriate to assume a proportion of index linked debt. But this should reflect the level of index linked debt the industry has on its books and should not represent a frontier assessment.

Concerns were raised with the depth of the index linked debt market and its future availability.

Small companies may be less able to issue index linked debt under current market conditions. If the monoline insurers need to be involved the availability of Artesian debt may be limited and it may be more expensive.

Key interest cover ratios assessed by Standard and Poor's are based on profit and loss interest charges rather than cash interest payments. It is therefore inappropriate to use index linked debt as a solution to financeability constraints.

Scepticism of new equity to solve financeability. Respondents considered it to be neither a practical nor an efficient solution.

Respondents asked for clarity on how we will determine the mechanism for NPV neutral revenue uplifts and decide early on financial ratios to be used in the financeability assessment.

Some respondents considered the rating agencies would typically expect higher financial ratios for the water only companies relative to water and sewerage companies to compensate for greater operational risks and less financial flexibility.

Our response:

It is too early to conclude definitively whether market mechanisms such as an assumption on index linked debt or equity based options, either individually or in combination, will ease the financing constraint completely particularly as expected

market conditions over the price review period will influence our financial assumptions. Nevertheless, market mechanisms are our preferred approach and we do not consider at this stage that a revenue uplift would be appropriate. As we have previously indicated, should we consider any such uplift, we would apply it in a NPV-neutral manner.

We will continue to consult with the financial markets to understand what they consider to be the most appropriate package of financial indicators and the level of those indicators. Whilst we acknowledge there has been some criticism of placing undue reliance on credit ratings, it is not our intention to develop alternative measures of financial capacity because there does not seem to be a sensible alternative. Consequently, we do not anticipate that the package of financial indicators will be significantly different to that considered at PR04. We would expect to use flexibly the levels for specific ratios within the overall package in assessing financeability. We will continue our dialogue with the credit rating agencies in respect of their rating of the smaller companies.

We believe that a market-evidenced assumption of index linked debt would be reasonable. In reaching this assessment we will take account of market conditions including ramifications for companies' future ability to raise index linked debt.

We continue to see the merits of equity based options as a means of easing the financing constraints brought about by the continuing large capital investment programme. We note that the success of new equity investment depends on a significant number of variables, not least prevailing market conditions, the allowed cost of equity and investors' perception of risk. We also observe that the appetite for equity investment has remained strong throughout recent turbulent market conditions.

We will continue our dialogue with the credit rating agencies in respect of their rating of the water only companies. The published information does not support a universal position on this issue.

5.4 Notified index

Issue: Notified index

Consultation views

The proposal to adopt the infrastructure output price index (IOPI) as the index of national construction received responses from water companies only. One believes the change to be unnecessary. The remaining respondents agreed in principle to the change.

Our response:

We will adopt the infrastructure output price index at the 2009 review.

5.5 Revenue forecasting

5.5.1 Link with long-term water and sewerage plans

There were no material or general comments in this area.

5.5.2 The form of the price control

Issue: Revenue corrected price cap

Consultation views

Most respondents supported the proposal to introduce a revenue corrected price cap, but suggested that we provide more detail on how the correction mechanism would work. Many were particularly interested in seeing a detailed proposal for the billing incentive. Two companies opposed the correction mechanism. One interpreted it as a revenue cap and a move towards rate of return regulation.

Our response:

We will introduce the revenue corrected price cap, as proposed. The new cap is not the same as a revenue cap, and we do not consider that it represents a step towards rate of return regulation. We remain committed to the principle of incentive-based regulation. [RD14/07](#) explains our position on these issues.

We will write to companies in April 2008 to explain the correction mechanism in more detail. In particular, we will provide more information about the billing incentive. We recognise and will address the issues that some respondents have raised about the effects on financeability, accounting arrangements and tax.

5.5.3 Modelling tariffs and revenue

There were no material or general comments in this area.

5.5.4 Household property numbers

There were no material or general comments in this area.

6. The incentive framework – delivering outputs and reducing costs

6.1 Defining outputs and assessing delivery

6.1.1 Operating expenditure rolling incentive

Issue: Opex incentive allowance

Consultation views

Only a small number of water companies raised issues about the opex incentive allowance. One company argued that we should adjust the determination opex used in the calculation of the opex incentive allowance to take account of the costs that we assumed were reflected in higher RPI or that formed part of a notified item. Another company misunderstood the way that tax is taken account of in the calculation of the opex incentive allowance.

Our response:

We set out our approach to the opex incentive allowance in [PR09/04, 'PR09: the opex incentive allowance and the out performance multiplier for 2005-10'](#) (October 2007), which is published on the [PR09 section](#) of our website. We do not intend to adjust the determination opex for costs assumed to be reflected in higher RPI or that form part of a notified item.

We remunerate the incentive allowance in price limits as part of the revenue requirement on a post-tax basis. We carry out this calculation outside Aquarius (our financial model). We have done this since the opex incentive allowance was introduced at PR99.

6.1.2 Rolling incentive mechanism for capital expenditure outperformance

There were no material or general comments in this area.

6.1.3 The overall performance assessment

Issue: Overall performance assessment

Consultation views

Most respondents supported our intention to undertake a review of the overall performance assessment (OPA) for the period 2010-15. Many felt that the OPA has been a useful tool in improving levels of service but that it no longer remains fit for purpose. A number of respondents included suggestions for how the OPA should be developed going forward. These included attaching a greater range of financial adjustments to the OPA, focussing on customer's priorities and expectations and including measures such as customer experience and carbon reduction.

For this review, a number of companies were concerned that we had suggested that we would use a wider range of price adjustments than previously used. A few companies also suggested that we should take into account actions such as K deferrals and statutory fines when determining price adjustments.

Our response:

We will publish a PR09 letter shortly setting out how the OPA might evolve for the next price review period.

We have set out in our March paper how we propose to make the price adjustments at PR09.

6.1.4 Addressing failure to deliver

There were no material or general comments in this area.

6.1.5 Shortfall adjustments for failure to deliver required outputs

Issue: Shortfalling (PR09/06)

Consultation views

Some industry respondents express disappointment with a lack of consultation on this approach and considers that the policy is retrospective and inconsistent with the principles of better regulation.

There is a lack of detail about how the adjustments will be made and what timescales are being used.

Some companies consider the shortfall methodology places an unreasonable amount of asymmetric risk for companies.

Some companies consider it to be vital that at PR09 they understand what outputs they are signing up to.

Our response:

We see no reason to change our overall policy on logging down and shortfalling. Consumers expect companies to deliver all the outputs associated with price limits, and it is right that bills should be adjusted where these outputs have not been delivered. This is a key element of our overall approach to protecting consumers' interests.

Some respondents focused on our approach to shortfalling, where companies fail to deliver stable serviceability. The 2004 final determination was made and accepted on the basis of maintaining (or achieving and maintaining by due dates) stable serviceability. This was clearly set out as a regulatory output at the time and in subsequent communications ([MD212](#)) and dialogue with affected companies. For companies with less than stable serviceability in 2004 the timescale for achieving and maintaining stable serviceability was set down at in the final determination. [PR09/06](#) set out further details on our approach to making judgements on shortfall adjustments, should these prove to be necessary.

PR09/06 does not set out a mechanical approach to judgements in these areas, particularly for outputs that are expressed as a level of service or performance not tied to a specific project. We will need to take account of the particular circumstances for each company, and PR09/06 sets out the factors we will take into account.

We agree that it is important to ensure clarity in the specification of PR09 outputs. In particular for serviceability we aim to agree reference levels and control limits, based on the evidence presented by companies. Where we do not accept the output proposals put forward by companies, we will set out our expectations in the determination. For flooding from sewers we aim to sue the register positions to inform delivery of outputs, gain placing the responsibility for activity needed to deliver agreed outputs with the company.

7. Respondents and responses

The list of respondents and their associated responses can be found on our [website](#).



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