July 2013

Water today, water tomorrow

Setting price controls for 2015-20 – final methodology and expectations for companies' business plans

OFWAT

About this document

Over the past three years, we have been developing our approach to setting price controls for each of the five years between 2015 and 2020, based on the principles we set out in 'Future price limits – statement of principles'.

We have engaged extensively with stakeholders on our approach, through a series of consultations, workshops and meetings that culminated in two consultations published earlier this year:

- 'Setting price controls for 2015-20 – framework and approach' (our '**methodology consultation**'), which set out our proposed methodology for the 2014 price review; and
- 'Setting price controls for 2015-20 – business planning expectations' (our '**business planning consultation**'), which set out our proposed risk-based approach to reviewing companies' business plans, and our expected data requirements for the 2014 price review.

This document sets out our final approach to setting price controls for 2015-20. The views and input we have received from our stakeholders – both through written responses to our consultations, and through our wider programme of engagement – have been an invaluable input to our decisions.

We look forward to continued productive engagement with, and involvement of, all our stakeholders as we move forward into the price setting process.

Correction

Table 4 on page 77 was updated on 26 July 2013.

Contents

Key messages

- Our final methodology for setting prices builds on many of our tried and tested approaches and at the same time introduces important new measures that will help the water sector in England and Wales tackle new and emerging challenges.

- Our changes are already contributing to a changing culture in the water sector. We are seeing companies respond by taking ownership of their business plans and developing those plans through much more extensive customer engagement than we have seen before.

- These changes will drive clear and significant benefits for customers and the environment. We estimate that setting separate retail controls and encouraging more water trading where it is efficient will deliver £2 billion of net benefits. And there will be further benefits to be gained through our efficiency challenges as we deliver the price review.

- We are encouraging companies to develop innovative, efficient solutions to long-term delivery for their customers, now and in the future, and for the environment. We want to see companies develop solutions with their customers that are good for the environment and we will use our abstraction incentive mechanism ('AIM') to encourage this by ranking companies and comparing their performance in reducing damaging water abstractions.

- While we have modernised our approach to price setting, we have also preserved core elements of our framework to enable companies to continue to access low-cost financing. This includes continuing to use a weighted average cost of capital in setting companies' controls for less customer-facing ('wholesale') services. This will ensure ongoing investment in improving services while keeping customers' bills down.

- Under our approach companies will take full responsibility for planning their business and listening to their customers, and not simply tick regulatory boxes. We have also challenged them to become more transparent to make sure they maintain their legitimacy with their customers.

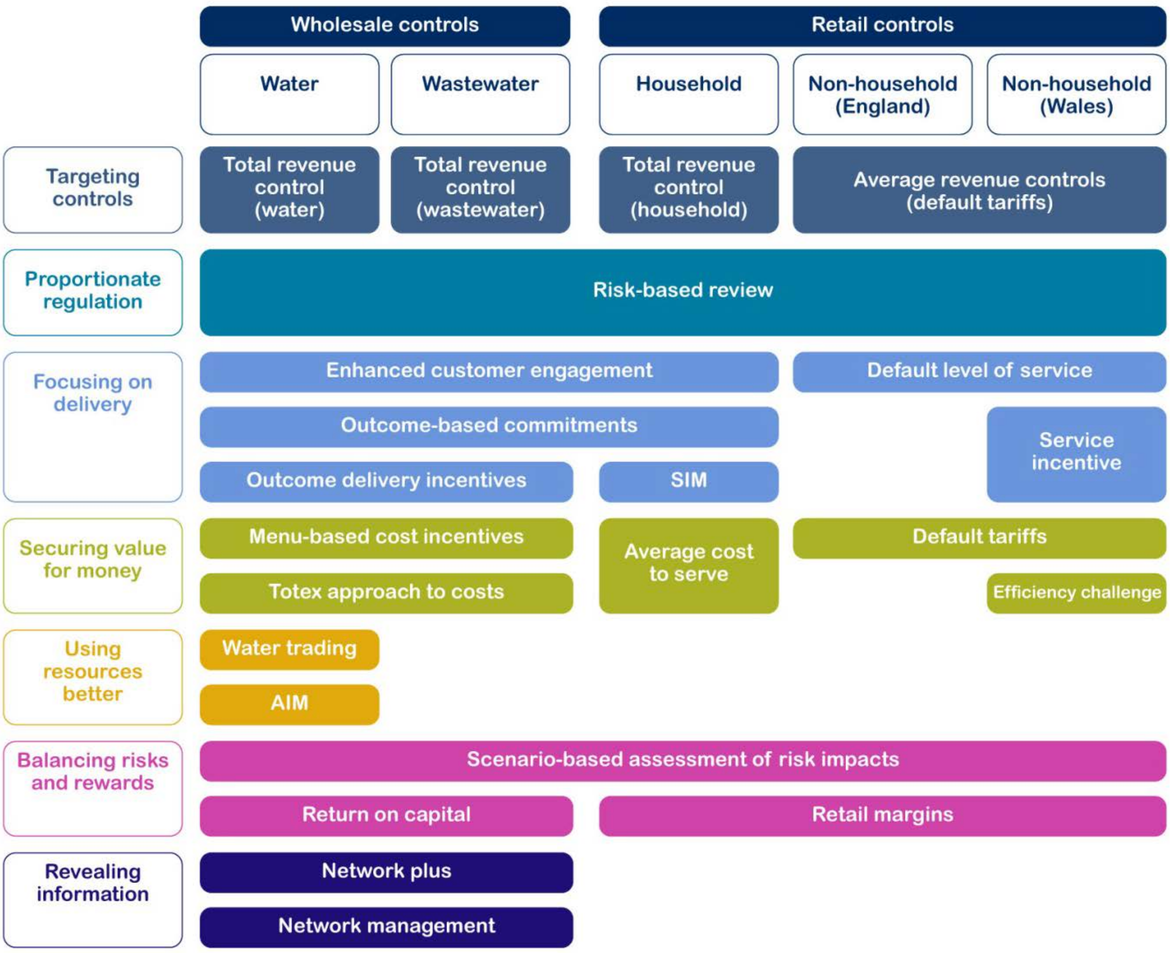
- It is now up to companies to use the flexibility and tools we have given them to respond to the challenges from their customers, environmental stakeholders and policy makers. This begins with them each preparing a high- quality business plan for 2015-20 – and sending it to us by 2 December 2013.

1. The overall framework – executive summary

Over the past three years, we have been developing a new, improved approach to setting price controls, based on the principles we set out in 'Future price limits – statement of principles'. During that period, we have carried out an extensive programme of engagement with our stakeholders – including many formal consultations, informal workshops, events and meetings.

We are grateful for this engagement and all the input we have received. Stakeholders' views have very much helped shape our final approach to setting price controls for 2015-20 – which is set out in this document, and illustrated below.

Figure 1 Overall framework for setting price controls for 2015-20



We are retaining many aspects of our approach to price controls which work well, and provide certainty and stability for companies and investors in those companies – for example, the familiar form of RPI±K in the wholesale control, and the use of the regulatory capital value (RCV). And we are also confirming a number of significant changes to our approach, both in terms of the controls we will set and the approach and tools we will use to set them.

Some of our changes remove aspects of regulation that were too prescriptive, or had the potential to distort companies' decision making – for example, our move to assessing costs on a total expenditure ('totex') basis removes any undesirable incentives for companies to seek capital expenditure-intensive solutions where there may be better alternatives.

So our changes build on the successes of the past, and update and modernise our approach to help tackle the new and emerging challenges faced by the water and sewerage sectors.

We will make changes to **target our price control regulation** better. For the first time, we will set separate controls for companies' wholesale and retail activities – allowing us to set more effective incentives for the different parts of the value chain, and support and facilitate the development of the proposed competitive market for retail services to non-household customers in England.

To deliver a **proportionate price setting process**, we will put an assessment of the quality of companies' business plans at the heart of the price setting process, using it to focus our scrutiny and challenge where it is most needed – and where we can deliver the greatest benefits for consumers (including current and future customers and the environment). We will complement this approach with a suite of powerful incentives for companies to deliver high-quality plans. This means that Boards of companies should focus on what their customers want rather than what the regulator wants. We stress the importance of the role of company Boards and the need for them to have good governance arrangements and ownership of their business plans.

To encourage a greater **focus on delivery** and the **outcomes customers want**, we have embedded customer engagement in the business planning process, giving companies' Boards greater ownership of – and accountability for – how well they deliver for customers and the environment in the long term.

To secure the best possible **value for money** for customers, we are tailoring our approach to setting price controls to reflect the different characteristics of wholesale and retail service provision, and the proposed scope of competition for English non-household customers. We expect that the reforms set out by the UK Government in the Water Bill will, by allowing non household customers to choose their supplier, empower them to demand a better deal. We will continue to regulate to protect this class of customers in Wales where the Welsh Government has decided not to develop the option of customer choice.

We are also changing the way we assess wholesale costs to drive **value for money** for customers, efficiency, and ensure companies are free to make the right investment decisions. Our move to totex should allow companies to decide on the right investment solution to drive benefits for their consumers, rather than one that is influenced by the way the regulator looks at costs.

To encourage better, **more sustainable use of water resources** we are introducing targeted incentives to encourage efficient water trading and to discourage the most damaging over-abstractions.

To **balance risks and rewards** fairly between customers, companies and their investors, we will take a systematic approach to assessing risks. This will guide our judgements on the overall package of price controls, ensuring it is both financeable for companies and affordable for customers now and in the future.

Finally, to help improve the way we set price controls for 2020 and beyond we are introducing new tools designed to **reveal information** about companies' water and wastewater networks.

1.1 Targeting controls

In 'Future price limits – statement of principles' we explained why we wanted to better target our price controls – in particular, by setting separate controls for companies' wholesale and retail activities. There are some important benefits that come with setting separate controls:

- better, more effective incentives for retail businesses that are distinct from those that apply to the much larger wholesale businesses;
- an increased likelihood that retailers will place efficiency pressures on wholesale businesses; and
- supporting and facilitating the development of the proposed competitive market for retail services to non-household customers.

We therefore confirmed in our methodology consultation that we would introduce **separate controls for wholesale and retail** parts of companies' businesses. We also confirmed that we would set two binding retail controls for each company – one for their **household customers**, and one for their **non-household customers**. This is because we need to make sure that household customers continue to be protected through price and service regulation, but we must also facilitate the UK Government's reforms to legislation to allow non-household customers to choose their retail supplier. We will continue to regulate to protect non-household customers in Wales where they will not have the option to choose supplier.

1.1.1 Wholesale form of control

We now confirm that we will set **two binding wholesale controls** – one for water and one for wastewater services.

For both wholesale controls, we will continue to index price controls to the Retail Price Index (RPI), using an **RPI ± K** approach – this retains the stability and certainty that ensure the water and sewerage sectors continue to attract low-cost financing in the asset intensive parts of the value chain.

The form of the wholesale controls will be **total revenue controls** that cover all revenues from wholesale activities, including revenue and cash receipts from connection charges. We have decided not to introduce annual change factors for allowed revenue, but companies will have some extra **flexibility to adjust charges** within the control period to allow them to manage unexpected changes in demand and to smooth price changes.

1.1.2 Retail form of control

We have already confirmed that we will **allocate all of the existing RCV to the wholesale business**, including for existing retail assets, and have already confirmed that for the less asset intensive retail businesses, **RPI indexation is not appropriate**.

We now confirm that the **household controls will be total revenue controls** with an annual revenue adjustment factor to reflect the cost differences arising from differences between actual and expected customer numbers and levels of metering.

In line with our proposals for the wholesale control, in the household controls we will **allow companies some flexibility to adjust charges** within the price control period to minimise differences between allowed revenues and actual collected revenues.

We confirm our view that setting **average revenue controls per customer type for non-households** is the most effective option, and will ensure that there is a degree of backstop protection for customers while companies compete for customers alongside other retailers. So the non-household controls will set limits on the average revenue per customer for each customer type – for a 'default tariff'. Non-household customers served by companies wholly or mainly in Wales will still be subject to a regulatory efficiency challenge and a service incentive to protect them in the absence of choice.

We confirm, for **non-household controls**, we will adopt a **gross margin approach**, per customer. By this we mean default tariffs will use an allowed retail charge that will be added to the wholesale charge. This is the most effective and proportionate form of control as it means that the controls on default tariffs will not need to be reset every time wholesale charges change, or new customers are connected or disconnected.

1.1.3 Defining retail services

Companies need to know what activities and services are covered by the wholesale and retail controls. We will define retail activities in a way that ensures costs are allocated properly for:

- the purposes of setting appropriate retail and wholesale price controls; and
- to enable new entry into the contestable retail market.

The wholesale business is defined by exception, so that it includes all regulated activities and services that are not part of the retail business.

In our methodology consultation, we confirmed our position on most of the items included in the retail control and we now confirm the remaining items.

Targeting controls – final position – retail services

A single definition of retail activities and services that applies from the start of 2015-20, and includes:

Customer services including:

- billing;
- payment handling;
- remittance and cash handling;
- vulnerable customer schemes; and
- network and non-network customer enquiries and complaints.

Debt management and doubtful debts

Meter reading

Other operating costs including:

- decision and administration of disconnections and reconnections;
- demand-side water efficiency initiatives;
- customer-side leaks;
- other direct costs;
- general and support expenditure;
- scientific services; and
- other business activities.

Developer services

- providing developer information; and
- administration for new connections.

Local authority rates

We confirm our view that both **demand-side water efficiency services and customer-side leak repairs** are best carried out in the **retail** part of the business, since these activities are customer facing activities – both the household and non-household retail price controls will have costs included for these services. Under the household price control an allowance will be made for the lower of the average cost per customer across the industry or the actual cost per customer that companies currently spend on these activities. The full cost of the existing provision of these activities will be included under the default tariff arrangements for non-household customers.

Retailers will have appropriate obligations to assist wholesalers in the management of the supply and demand balance. In addition, companies may propose as part of their wholesale plans – where they have customer support – additional outcome delivery incentives (ODIs) in this area for services to be delivered, under contract by the retailer or some other party, and associated efficient costs will be allowed in the wholesale price control.

We explain our decision to **allocate developer services to retail** – with the retailer responsible for arranging connections on behalf of the developer but the costs of connections remaining part of the wholesale price control. This will encourage a more customer-focused approach and facilitate competition in the provision of connections. We expect this change to help address some of the difficulties in this market that have been identified both by the 2011 'Review of Ofwat and consumer representation in the water sector' (the 'Gray review'), and through the legislative changes in the Water Bill.

Our definition of retail services is consistent with the Scottish water retail market, allowing for a more effective joint market for non-household retail services with Scotland.

1.2 Proportionate regulation

In 'Setting price controls for 2015-20– business planning expectations' (our business planning consultation), we set out how, in line with our future price limits principle of 'ownership, accountability and innovation' we intended to make **a step change away from a prescriptive approach** to business plans.

In making this change we are responding to feedback, including from the 2011 Gray review, that **both companies and Ofwat need to change their approach** to business plans. Included in the conclusions of the Gray review were three that are particularly relevant. The review said that Ofwat:

- "…needs to **reduce the burden of regulation** on the companies to encourage them to be more flexible and innovative in their approach."
- "…goes **too far into the detail of company business plans** and that, as a result, the companies are very Ofwat focused and very cautious and conservative in their approach. Rectifying this will **require a substantial change of approach by both Ofwat and the companies** it regulates."
- "…should take steps to **return ownership of business plans to the companies**."

We agree that, over successive price reviews, our approach to business planning grew more prescriptive, and our requirements and guidance for companies' business plans became more extensive and more detailed.

We are now confirming our new approach, which **places the onus on company Boards to own and be accountable for plans**. We have not issued detailed and prescriptive guidance explaining how companies should structure or present their business plans. Instead, we focus on creating strong incentives for companies to submit high-quality plans and on company Boards to ensure appropriate governance and ownership of those plans.

1.2.1 High-quality business plans

While we confirm our approach of not giving detailed guidance on business plans, we recognise that it is helpful for us to make as clear as possible what we consider the general qualities of a high-quality business plan would be, so we have set out more detail building on the description proposed in our business planning consultation. **A high-quality business plan**:

- is designed to deliver good outcomes for current and future customers and the environment;
- has a coherent narrative based on sound reasoning and contains proportionate evidence;
- will ensure that a company meets its statutory obligations and enables the relevant regulators to confirm this in the customer challenge group (CCG) report;
- is based on good-quality engagement with customers and consumers, and the results of this engagement are reflected in the proposed outcome commitments, and the plan more generally;
- is cost efficient, containing accurate projections and estimates;

- proposes a reasonable balance of risk and reward between customers, investors, and other stakeholders, with efficient proposals to share 'pain and gain' with customers;
- is both affordable and financeable;
- comes with a high level of assurance – in the form of a statement from the company's whole Board that the plan is of a high quality, will ensure that it meets its statutory obligations, and that estimates and data have been arrived at appropriately, and independently of other companies and competitors; and
- does not seek to game the regulatory process in any way.

We want each company's Board to **own and be accountable for the business plan** they submit for the 2014 price review (PR14). This is consistent with our wider policy set out in 'Delivering proportionate and targeted regulation – Ofwat's risk-based approach'. We will require that **whole company Boards provide assurance** that their plan is a high-quality plan.

In addition to the assurance that the plan is high quality, each company Board also needs to explain the governance processes of the Board – and demonstrate how it has provided strategic leadership, a transparent process, and compliance with the relevant licence conditions and the 'UK Corporate Governance Code'.

1.2.2 Incentives for high-quality business plans

We confirm our approach to implementing **a risk-based review** containing **reputational, procedural and financial incentives** for companies' Boards to produce high-quality business plans. Our risk-based review will:

- assign each element of each company's business plan to one of three processes – **enhanced, standard or resubmission** – which determines the likely level of scrutiny and challenge of that element; and
- assign each company to one of three categories – enhanced, standard or resubmission – which determines **procedural, reputational and financial benefits**.

We have carefully considered those representations that suggested we should drop the resubmission category entirely or drop the resubmission process for retail plan elements.

The resubmission category is an important part of achieving our objective to return ownership of plans to companies' Boards – the resubmission process allows the company to reassess those areas of its plan that fall seriously short, rather than the regulator reworking the plan. And we conclude that incentives for high-quality plans, in particular reputational incentives, are made stronger by the prospect of companies with plans that fall short being placed in a published resubmission category.

The retail elements of the service are particularly important. These are the services through which companies directly interact with their customers and one of the main objectives for our changing approach is to encourage greater focus on these activities. So we are not convinced that it is in customers' interests to reduce the incentives on companies to get each part of their plan right, and we cannot see any reason to scale back incentives for the critically important retail part of the plan.

We confirm our package of incentives for high-quality business plans comprises:

- publishing our assessments of each company's overall business plan quality as early as is practical to do so creating **reputational incentives** – our proposals should give a clear signal to investors and other stakeholders to allow them to identify those companies that have – or do not have – high-quality plans;
- tailoring our approach to scrutiny and challenge according to our assessment of the quality of the elements of companies' plans creating **process incentives,** focusing regulatory effort where it is needed and reducing costs;
- tailoring the process for setting price controls according to our assessment of overall business plan quality – including early draft determinations for enhanced companies and potentially the option of early final determinations to deliver **procedural incentives**; and
- **financial incentives** for enhanced category plans – enhanced category companies will have access to enhanced menus with greater shares of cost outperformance, and will be better off overall than companies in the standard category.

1.2.3 Risk-based review tests

Our risk-based review will contain tests for high quality in four key areas.

- **Outcomes** – the company's key proposed deliverables for consumers, including current and future customers and the environment, and the incentives associated with delivering them.

- **Costs** – the costs, for both wholesale and retail businesses, associated with delivering the company's proposed outcomes.

- **Risk and reward** – how the company's proposals balance risk and the rewards for bearing those risks between consumers, including current and future customers and the environment, and the company and its investors.

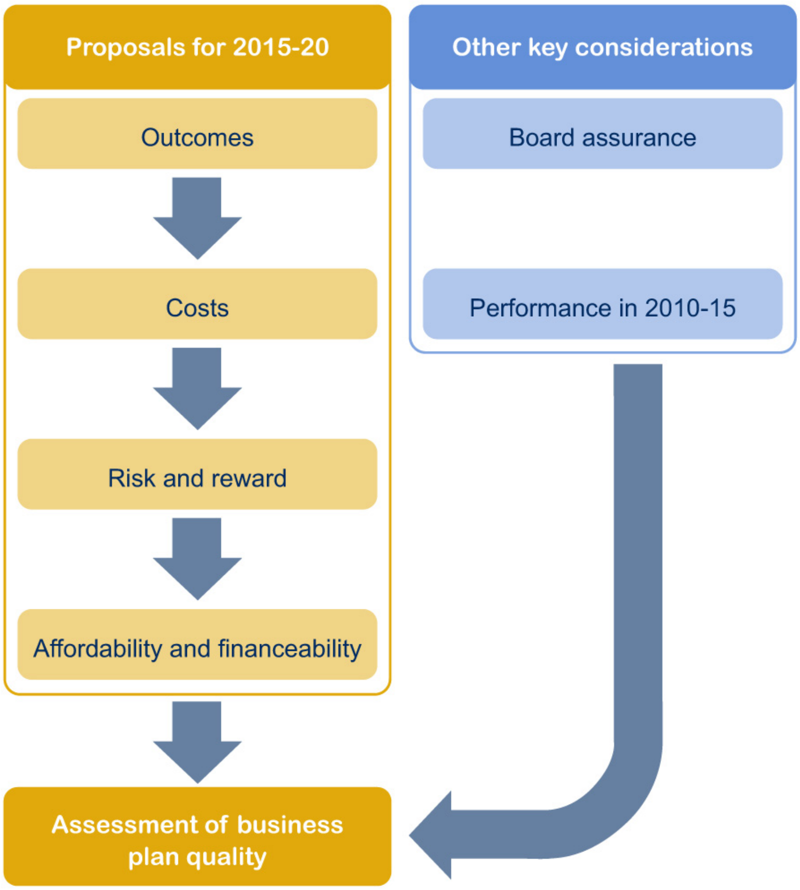
- **Affordability and financeability** – the impact of the company's proposals on customers' bills, and its ability to finance its functions.

For each part of our assessment, we propose to test companies' business plans against a number of different key assessment criteria. In most cases, we propose to carry out **separate tests for each element of companies' business plans** (household retail, non-household retail, water wholesale and wastewater wholesale), but there are some cases where we will **also apply tests at a whole-company level**.

We will also need to look at **companies' performance in 2010-15** – both to determine how differences between actual and expected performance should be reflected in prices for 2015-20, but also because some aspects of past performance are relevant to the credibility of a company's plans. For example, a company with a history of poor customer service may be expected to plan for substantial improvement, and at the same time will have to work hard to provide enough evidence to support a credible plan that anticipates and promises a dramatic positive improvement in customer service. Such a company would clearly have a higher bar to reach in terms of evidence than one that was already performing at the frontier in terms of service.

As part of our assessment of performance in 2010-15, we will allow companies to put forward specific proposals for investment in 2014-15 to deliver outcomes for 2015-20. Companies will bear the additional costs of financing this dedicated 'transition investment', and we will exclude the associated expenditure when determining incentive rewards and penalties under the capital expenditure incentive scheme (CIS). This will ensure the transition between our current and future incentive frameworks does not disrupt efficient investment planning, and allow companies to bring forward investment plans where it is efficient to do so.

Figure 2 Approach to the risk-based review



We appreciate that, in order for companies to strive to pass **the high bar for the enhanced category**, they need to believe that they have a realistic prospect of obtaining the rewards on offer. That is why, in this document, we make it clear that **a very high-quality plan will secure enhanced status**, and will not fail to do so because of technicalities in the way we apply our tests.

In the delivery phase of the price review, we will set out more detail about the process we will follow in conducting the risk-based review, which will be robust, transparent and fair. But we confirm now that companies will be invited to present their plans, helping to ensure that Ofwat fully appreciates the coherence of plans early in the price setting process.

1.3 Focusing on delivery

In the past, we have made judgements on what Boards of companies should deliver. We are changing our approach so that companies' Boards:

- focus more on the **outcomes customers want**;
- **deliver for consumers**, including current and future customers and the environment, in the long term; and
- take more ownership of – and accountability for – **what they deliver**.

We have already embedded customer engagement in the business planning process. Each company and its Board now have a CCG, which will challenge:

- the quality of their customer engagement; and
- how well their proposed outcomes, associated commitments and delivery incentives reflect their customer engagement, and wider consumers' views and priorities.

We confirm our broad approach to outcomes as set out in our methodology consultation. There are three stages to the process.

- Company Boards will develop and propose outcomes and associated commitments and incentives that reflect their customers', and wider consumers', views and priorities.

- The CCG will challenge the quality of companies' customer engagement and the extent to which the business plans put forward by their Boards reflect their customers' views, and wider consumers', and provide an independent report to us at the same time as companies submit their business plans. The report may also include views from CCG, including the environment and quality regulators, on whether a company's plan will ensure it meets its statutory obligations.

- We will make the final assessment of companies' outcome commitments as part of our risk-based review of, and if necessary challenge to, companies' business plans and use the views of each CCG as a key input into this.

1.3.1 Outcomes

We want to ensure that companies' outcome commitments reflect what their customers want and value – so **ODIs will need to reflect the value** of the outcomes delivered to customers.

Where appropriate, we expect companies to put forward proposals for **both penalties and rewards**, according to the flexible framework we have set out. The proposal should include penalties if companies fail to deliver or where performance deteriorates and, where justified by customers' willingness to pay (WTP), rewards for outperformance. In some circumstances, it may be appropriate for companies to propose to **trade-off within a package of delivery commitments.**

1.3.2 Requiring consistent outcomes – SIM and leakage

There are benefits to requiring that some outcomes are implemented by all companies – either because an incentive mechanism works on the basis of comparison between companies, or because a particular outcome is already known to be of significance to customers or the environment. We have set out two such areas.

- Since the **service incentive mechanism** (SIM) has successfully driven improvements in customer service during 2010-15, we will continue to use this form of mechanism for all household customers in England and Wales.

- We expect all companies to put forward a performance measure and associated ODI on **leakage,** and if we are consider proposals fall short, we will substitute our own incentive.

1.3.3 Default levels of service for non-household customers

In England, we confirm that we will use the Guaranteed Standards of Service (GSS) to define the default level of service for non-household customers. This provides a backstop form of protection for non-household customers where we expect market forces to ensure that they receive a good deal.

As most non-household customers in Wales are unlikely to be able to choose their supplier, we are strengthening the protection for those customers by introducing a separate non-household SIM for Wales. We will consult further on the detail of this in the autumn.

1.4 Securing value for money – wholesale

In order to set both wholesale controls, we need to determine the appropriate revenues that companies need to collect through their water and wastewater charges – companies' **allowed wholesale revenues**.

The high-level approach we will take to setting allowed wholesale revenues is the same for both water and wastewater controls, and is driven by three inter-related policy decisions:

- how we determine the efficient level of expenditure (**cost assessment**);
- how we set incentives for companies which encourage efficient delivery and reductions in wholesale expenditure (**cost performance incentives**); and
- what proportions of that expenditure should be recovered from current – and future – customers (**cost recovery**).

1.4.1 Cost assessment – a totex approach

We have decided to confirm our consultation proposals, and will implement a **totex-based approach** to assessing efficient expenditure for the next price review.

We are making this change to move to a totex approach because assessing operating and capital expenditure separately can lead to different incentives for companies to deliver operating and capital efficiency savings, and might contribute to a bias towards capital intensive business solutions and expenditures.

Some companies said we should make available our cost assessment models during 2013. We remain of the view that companies should focus on formulating business plans which deliver for their consumers (including current and future customers and the environment) in the long term, rather than being driven by regulatory models of cost assessment.

We intend to release the base data, including the data that will be used to calibrate our main cost assessment models, in the second half of 2013. We will be fully transparent in setting cost baselines in 2014.

1.4.2 Cost performance incentives

Menu regulation can provide extra incentives for companies to reveal information, allows for some extra flexibility in setting totex baselines, provides some additional flexibility in setting efficiency sharing factors and allows companies to better manage risks and rewards. Since we consider that the overall timetable for the price review can be arranged to allow for the use of menu regulation, we intend to use menus in the price setting process.

We will set **menus as part of water and wastewater price controls** for enhanced and standard companies, with companies making choices toward the end of the price control review. We intend to publish proposed menus for enhanced companies and first drafts of menus for standard companies alongside their respective draft determinations and initial baselines respectively in 2014.

1.4.3 Cost recovery

A significant proportion of companies' wholesale expenditure comes from investment in long-lived assets. Both current and future customers benefit from that investment, and we therefore seek to ensure that both current and future customers pay a fair proportion of the costs of investment. Since privatisation, we have used RCVs to achieve this.

We are confirming our approach for **companies to propose the proportion of its expenditure to be recovered through its RCV**. We will challenge companies' proposals, where required, through the risk-based review process.

Ofwat has always set separate indicative price controls on water and wastewater activities – and these price controls have been based on an original split of privatisation asset values between water and wastewater respective RCVs. Even though some of these values may no longer be accurately split between the two services we have decided not to mandate changes to the existing notional split between water and wastewater RCVs at this price review but companies should seek to put forward cost-reflective RCV splits in their business plans – provided their proposals remain both affordable for customers and financeable.

1.5 Securing value for money – retail

In our methodology consultation we confirmed that we would set retail controls that offer customers an appropriate level of protection on service and price, taking account of their ability to choose their supplier– both now and in the future. So, we confirmed that we would use:

- an **average cost to serve** (ACTS) approach to set retail controls for all **household** customers; and
- **a default tariff approach** to set retail controls for **non-household customers** with an efficiency challenge for customers in Wales.

Our reason for distinguishing between customers with and without choice in our price controls is because market forces will protect those customers that will, or are expected in the future to, have choice. But for those without it, including all household customers and most non-household customers in Wales, price controls are necessary to protect them from monopoly companies charging more than they need.

1.5.1 Household controls – average cost to serve

In calculating individual company ACTS, in our methodology consultation we said that our preferred option was to use a measure of unique customers. After carefully considering the responses to our consultation, we have decided to use **a measure of unique customers adjusted for economies of scope** – this is in response to the evidence presented in the consultation responses, and in order to ensure that the controls are fair for all companies regardless of whether they are water and sewerage, or water only, companies.

We have decided that it is most appropriate to use **actual costs, rather than forecast costs**. Using actual costs is a simple and pragmatic approach which most stakeholders supported.

We also confirm that we will **adjust the ACTS to account for levels of metering.** We also confirm the criteria which companies must meet in order to demonstrate that they have unavoidable costs differences, and not just inefficiencies, before we will accept that it is appropriate to make further adjustments to ACTS, including any adjustments for bad debt.

We have decided to use a **three-year glide path** for companies with **actual existing costs above ACTS**, which strikes a balance between delivering savings for customers while not setting unachievable cost reduction targets for high-cost companies.

For companies that have actual **costs below ACTS**, we have decided – to protect customers – that we will set **allowed revenues based on actual costs**. These companies will be able to benefit from future outperformance against their existing costs.

We have decided to **include a net margin in the household retail control** ensuring the price for retail household services covers all relevant costs including a reasonable return, including on future investment made in providing quality services to customers. We will apply a single margin rule to ensure that companies do not gain a return on their existing retail assets twice.

We will not be indexing retail price controls to RPI automatically. If companies consider that uncontrollable input costs exist for household retail activities then they should submit clear and compelling evidence to support their claims. If the evidence is persuasive, we will take the risk posed by these costs into account in setting the level of net margin.

1.5.2 Non-household controls – England

In order to set default tariffs for each company, we need to determine:

- the **different customer types** for which we will set default tariffs; and
- the **appropriate average retail revenue per customer** for each customer type.

We confirm our approach will be to **use each company's proposed tariff structures** to determine the different customer types for which default tariffs will be set. This is a simpler and more proportionate approach than setting national customer types or tariffs, and it will minimise any incidence effects on prices for different customer groups.

We have decided that allowing companies to **set default tariffs within a range** of allowed average revenue (or gross retail margin) per customer type for each company strikes the best balance between intervention to protect customers, and allow the market in England to develop and companies to respond flexibly – that is, we will use a 'tariff corridor' approach for 2015-20.

The **non-household control**, as for the household control, will **include a net margin** to secure efficient financing of capital employed in providing non household services, encourage efficient entry and remunerate efficiently incurred risk. If companies consider that there are uncontrollable cost pressures that need to be taken into account then they should submit clear and compelling evidence, and if that is persuasive we will take these cost pressures into account when setting the net margin for the non-household controls.

1.5.3 Non-household controls – Wales

Our proposals for default tariffs in England assume that, in line with UK Government policy, non-household customers will have the ability to choose their retailer from 1 April 2017. Because of this, we do not think we need to introduce any additional price protection for these customers, and can reduce the burden of regulation.

We propose to adopt a similar methodology to setting **default tariffs for non-household customers in Wales** in that the customer types will be based on companies proposed tariffs. However, to ensure that we can continue to protect these customers in the absence of choice, we intend to adopt additional safeguards.

We confirm that we will set an up-front non-household **efficiency challenge** for companies operating in Wales based on comparison with equivalent tariffs available to customers in England – these tariffs are likely to provide the best available indication of efficient non-household costs. We will be able to use information that we will collect in any event, for the purposes of setting default tariffs in England, so there will be no additional burden on companies serving customers in England.

These changes are currently focused on companies who operate 'wholly or mainly in Wales'. This reflects the current arrangements that dictate the application of Welsh and English water policy and legislation, which have generally followed company areas of appointment rather than the border between England and Wales. If in the future, boundaries change to more closely reflect the border rather than the company areas, this may have implications for the price controls of companies who operate in both England and Wales.

1.6 Using resources better

There is scope for significant benefits to consumers, including current and future customers and the environment, if companies make better use of water resources, including:

- reduced financial costs;
- increased resilience of customers' water supplies; and
- reduced pressure on the environment caused by abstraction – particularly in areas where water is scarce.

Over the long term, we expect our new totex approach to wholesale costs to encourage better, and more efficient, decisions on the use of water resources – including decisions on whether to develop new resources or purchase water from another water company or a third party. The UK Government's proposed long-term reforms to the abstraction licensing regime will also have a key role to play.

But we also want to improve the way companies use resources in the short term. So, we are confirming the introduction of two incentives to drive changes in company behaviour:

- **water trading incentives** – designed to encourage companies to trade water where it is beneficial to do so; and
- the **abstraction incentive mechanism (AIM)** – designed to reward or penalise companies depending on their levels of abstraction at low flows from environmentally sensitive sites.

1.6.1 Water trading

In the water trading incentive, we confirm that we will introduce **incentives for both new water exports and new water imports**. For all new qualifying exports in 2015-20, we will allow exporters to retain 50% of the lifetime economic profits (that is, the profits over and above the normal return on capital invested).

Importers will benefit from totex efficiency sharing incentives. We will also allow **importers to retain 5% of their costs** from new qualifying imports during 2015-20. Companies will benefit more from this incentive if they bring forward new imports earlier in 2015-20.

As well as setting incentive rates, we have considered carefully how best to protect customers and secure efficient trades. We consider that we can achieve our objectives effectively through the use of a **cap on total annual import incentive rewards of 0.1% of water activity turnover in any year of the control period** and through **trading and procurement codes** which will require companies to be transparent about water trading, allowing for assurance on whether trades are efficient.

Our water trading incentives will apply only to relevant price regulated companies. In relation to transactions with new appointees, we will address whether and how we apply water trading incentives when we consult separately on the detailed form of a service incentive for new appointees.

1.6.2 AIM

Our proposal for AIM set out in our consultation was to provide specified rewards (and penalties) in price limits when a company reduces (or increases) abstraction at low flows at environmentally-sensitive sites compared to its baseline historic level.

It remains our view that a financial incentive is appropriate, but despite working hard alongside colleagues in the Environment Agency, and with companies, the data we need to set national financial incentives is not yet robust enough for us to set such incentives in the forthcoming price review. Setting national financial incentives using data that are not sufficiently robust risks exacerbating over-abstraction, rather than reducing it. We want to be sure that our incentives deliver the right outcomes.

Consequently, we propose that all parties work together to improve the data so as to create such incentives as quickly as possible, and no later than the next price review. We will also take the opportunity of seeking data on more than just band 3 (most environmentally sensitive) sites. Financial incentives could be introduced during the price review period if all companies consented to a licence change.

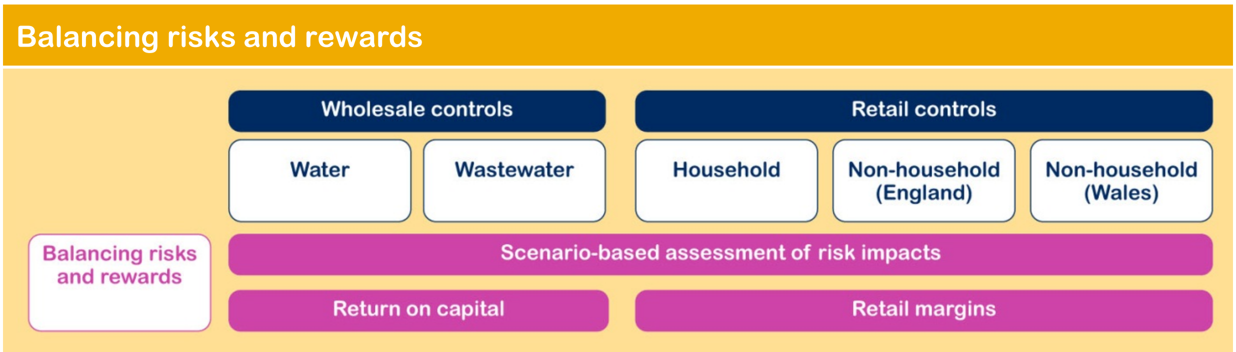
We will **implement the AIM during 2015-20 on a reputational basis**. Experience shows that companies place significant value on achieving high ranking in league tables that we set, even going so far as to link management incentives directly to them. The reputational incentive will therefore act as a powerful tool for changing abstraction patterns at the same time as allowing companies and the Environment Agency to improve the data and learn how the incentives might work when financial penalties and rewards are added.

In addition, we encourage companies to include targeted financial incentives within their outcomes packages where reliable local data is available and companies are able to put forward outcomes and incentives designed to reduce environmental damage due to over-abstraction.

If a company has set itself a well-designed, evidenced and stretching abstraction outcome commitment and delivery incentive, this will benefit the company within the reputational comparisons of companies under the AIM.

Consistent with the general approach to outcomes, we would expect any outcomes and ODIs to reflect customer preferences and WTP and to be challenged by customers and environmental stakeholders through the CCGs.

1.7 Balancing risks and rewards



We confirm our approach, proposed in our methodology consultation, to use an approach based on **scenario modelling to analyse risk** and explore the overall balance of risks to return on regulatory equity (RORE). We have responded to feedback from respondents, and simplified our approach, reducing the number of modelled scenarios required from companies. We have commissioned PricewaterhouseCoopers LLP ('PwC') to carry out further work in this area, and we are publishing PwC's report 'Economic assumptions for PR14 risk analysis' alongside this document.

In the methodology consultation, we also confirmed that we would continue to allow companies to earn a regulated return on their RCV as part of wholesale controls, and that we would do this using a **weighted average cost of capital** (WACC) approach.

There are three key parameters in the calculation of the WACC:

- **gearing** (the respective proportions of finance provided by debt and equity);
- the **cost of debt finance**; and
- the **cost of equity finance**.

We have done further work on the detail of WACC and are publishing PwC's report 'Cost of capital for PR14: Methodological considerations' alongside this document. We confirm that we will continue to use a **notional capital structure for setting WACC** taking account of the change in gearing levels since we last set price limits. These changes together with developments in other utility sectors suggest our notional gearing assumption should be in the range of 60% to 70%.

It remains the case, however, that highly-geared, securitised structures are untested against the full range of potential risks, and new risks may emerge that challenge these structures. So we now announce our intention to introduce a **financial structure monitoring regime**, to keep under review and assess the risks to customers posed by companies' financial structures.

We confirm that we will retain our existing approach to the cost of debt based on forward-looking expectations, and will use **a fixed cost of debt from 2015-20** – we consider that it would be inappropriate for us to change from our existing approach when prevailing debt costs are very low.

We also confirm that we will continue to use our existing approach to the cost of equity, based on the **capital asset pricing model (CAPM)**, alongside cross checks to other approaches and informed by our scenarios work.

In our methodology consultation, we noted that when deciding on retail margins, we need to think about the **payment terms between retailers and wholesalers**. This is important because the approach to payment terms affects the cash flow and hence the costs of working capital of wholesale and retail.

The issue of payment terms was discussed by the Open Water programme and we listened carefully to the views. We now confirm key principles including retailers paying wholesalers in arrears, and a consistent billing period and a consistent settlement period across the non-household market. More details on billing, settlement and credit requirements should be proposed by Open Water by the end of October.

1.8 Revealing information

We want to take steps in the next price control period to improve the way we regulate companies' monopoly network when we next set prices in 2019, through the phased introduction of two new tools:

- **network plus** – designed to reveal information about costs and revenues related to companies' network and treatment activities; and
- **network management** – designed to reveal information about companies' network management policies, practices and cost drivers.

We have decided to confirm our consultation proposals for network plus, and will introduce **two non-binding sub-limits** within the 2015-20 period:

- one for water, covering raw water distribution, water treatment and treated water distribution, but not water resources; and
- one for sewerage, covering sewage collection and sewage treatment, but not sludge treatment, recycling and disposal.

We have decided to introduce network management reporting for water networks and sludge gradually over 2015-20, and will decouple this from the price review, although we may still trial an incentive later in the price control period.

1.9 Other matters

This document marks the end of our main policy development consultations, and the price review now moves to its delivery phase.

Now we are at the end of the main policy development phase, we have updated our future price limits draft impact assessment, which was first published alongside our future price limits policy statement. This updated impact assessment has been prepared by PwC and shows that the earlier expectations of substantial additional benefits from our new price controls approach remain supported by our more detailed proposals – which are additional to the impacts expected by the Government from the measures in the Water Bill.

Our final price control methodology is in line with the changes to the legislative framework set out in the Government's Water Bill. Our changes are consistent with and support the objectives of the Strategic Policy Statements and guidance that we receive from the UK and Welsh Governments respectively. We also consider that the changes are in line with the current and future duties that Ofwat would be subject to following the Bill, including a new primary resilience duty. But there are always uncertainties associated with the passage of legislation and it is important to say that if there are delays to the passage of that legislation then we would need to consider and possibly re-consult on some aspects of our price review methodology.

We have already said that the deadline for business plans, and CCG reports, is **2 December 2013**. In line with our approach to step back from the detail of business planning, we confirm that we are not issuing any detailed guidance on what companies should include in their business plan narratives – **companies' Boards are free to set our their business plans in their own way**, making them accessible to customers, us, and other stakeholders.

Our **final data tables and supporting guidance**, updated to reflect comments from respondents to our consultation and our final policy positions, are now available. In setting out the data that we intend to collect, we have been careful to make sure that we specify the right amount of data – which is all the data we need to set price controls, but not more than we need. We also thought carefully about the information we specify to be submitted alongside data tables, which can significantly increase the overall burden on companies. We consider our approach will ensure this remains proportionate allowing companies to focus on delivering high-quality plans. Companies with very high-quality plans, which qualify for the enhanced category, can expect a reduced data burden compared to previous reviews.

We confirm that the assurance process for the submission of the data tables is the same as the assurance process for the plan as a whole – it is for company Boards to put in place whatever assurance processes they require in order to 'sign off' that the data submitted is accurate and complete.

At workshops between March and May 2013, we discussed options for resolving constraints on the price review timetable. We have decided that one of these options, allowing room in the process to **defer publishing final determinations to January 2015 if required**, would introduce sufficient contingency time into the timetable to ensure a successful process for companies and other stakeholders. While it is possible that final determinations may be published earlier, particularly for enhanced companies, companies should plan on the basis that final determinations may not be published until January 2015.

As the price review moves to its delivery phase, we will soon be in a position to give more information about the detailed timetable. We have listened to, and carefully considered, company views on the timetable. It is important that companies appreciate that the detailed timetable may change. And the timetable will vary by category – companies will not know which version of the timetable applies to them until they know the results of the risk-based review in 2014. We will publish more information about the timetable for the review in the autumn.

2. Targeting controls

In 'Future price limits – statement of principles' we explained why we wanted to better target our price controls – in particular, by setting separate controls for companies' wholesale and retail activities. We also set out the key benefits that arise from setting separate controls:

- better, more effective incentives for retail businesses that are distinct from those that apply to the much larger wholesale businesses;
- an increased likelihood that retailers will place efficiency pressures on wholesale businesses; and
- they support and facilitate the development of the proposed competitive market for retail services to non-household customers.

We therefore confirmed in our methodology consultation that we would introduce separate controls covering the **wholesale** and **retail** parts of companies' businesses. We also confirmed that we would set two binding retail controls for each company – one for their **household customers**, and one for their **non-household customers**.

To set effective wholesale and retail controls, we explained that we need to set out a clear **definition of wholesale and retail activities and services**. We confirmed our approach to a number of activities and services in our methodology consultation – we set out our final position on the remaining activities and services below.

We confirm our view that both **demand-side water efficiency services** and **customer-side leak repairs** are best carried out in the **retail** part of the business, since these activities are customer facing activities – both the household and non-household retail price controls will have costs included for these services. Under the household price control an allowance will be made for the lower of the average cost per customer across the industry or the actual cost per customer that companies currently spend on these activities. The full cost of the existing provision of these activities will be included under the default tariff arrangements for non-household customers.

Retailers will have appropriate obligations to assist wholesalers in the management of the supply and demand balance. In addition, companies may propose as part of their wholesale plans – where they have customer support – additional ODIs in this area for services to be delivered, under contract by the retailer or some other party, and these additional costs will be funded through the wholesale price control.

We explain our decision to **allocate developer services to retail** – with the retailer responsible for arranging connections on behalf of the developer (but the costs of connections remaining part of the wholesale price control). This will encourage a more customer-focused approach and facilitate competition in the provision of connections. We expect this change to help address some of the difficulties in this market that have been identified both by the Gray review, and through the legislative changes proposed in the Water Bill.

Our definition of retail services is consistent with the Scottish water retail market, allowing for a more effective joint market for non-household retail services with Scotland.

We also confirm in this chapter our approach to the **form of controls** for both wholesale and retail.

- We now we confirm that we will set **two binding wholesale controls** – one for water and one for wastewater services.

- The form of the wholesale controls will be **total revenue controls** that cover all revenues from wholesale activities, including revenue and cash receipts from connection charges. We have decided not to introduce annual change factors for allowed revenue, but companies will have some **extra flexibility to adjust charges** within the control period to allow them to manage unexpected changes in demand and to smooth price changes.

- The **household controls will be a total revenue control** with an annual revenue adjustment factor to reflect the cost differences arising from differences between actual and expected customer numbers and levels of metering.

- In line with our proposals for the wholesale control, in the household controls we will **allow companies some flexibility to adjust charges** within the price control period to minimise differences between allowed revenues and actual collected revenues.

- We confirm our view that setting **average revenue controls per customer type for non-households** is the most effective option, and will ensure that there is a degree of backstop protection for customers while companies compete for customers alongside other retailers. So the non-household controls will set limits on the average revenue per customer for each customer type – a 'default tariff'. Non-household customers served by companies wholly or mainly in Wales will still be subject to a regulatory efficiency challenge and a service incentive to protect them in the absence of choice.

- We confirm, **for non-household controls**, we will adopt a **gross margin approach**, per customer. By this we mean default tariffs will use an allowed retail charge that will be added to the wholesale charge. This is the most effective and proportionate form of control as it means that the controls on default tariffs will not need to be reset every time wholesale charges change, or new customers are connected or disconnected.

2.1 Defining retail and wholesale

In the methodology consultation, we confirmed two key aspects of our approach to retail definition:

- a single definition of retail activities, services and costs that applies to both retail controls (household and non-household) from the beginning of 2015-20, which we will keep under review in case changes are required over time; and
- wholesale activities and services defined by exclusion – all regulated activities and services that are not in retail are defined as part of wholesale.

We explained in our methodology consultation that we expect the retail definition to change over time – as it has in Scotland and other regulated utility retail sectors – but for now this definition is consistent with the Scottish arrangements which will also allow for a more effective joint-market for customer-facing retail activities between England and Scotland.

We also confirmed our position on most of the activities and services that we had considered including in retail, with:

- billing, payment handling, non-network calls, network calls, debt management, meter reading and decisions on disconnections (and reconnections) confirmed as included in retail;
- meter ownership, trade effluent compliance monitoring, disconnections and reconnections (physical activity) confirmed as not included in retail; and
- meter installation, maintenance and replacement confirmed as not included in retail (but with a role for retailers in determining meter functionality and capability).

Respondents broadly agreed with our confirmed direction. Comments focused mainly on two areas.

- **Network calls** – although most respondents supported including network calls in retail, some companies opposed this approach, citing the potential for increased coordination costs (arising from increased interactions between retailers and wholesalers, and the need to ensure that network calls can always be answered).

- **Metering** – where the Consumer Council for Water (CCWater) raised concerns that the split of metering between retail and wholesale could mean that wholesalers do not consider the full additional costs of metering when considering whether to roll-out metering.

There were three specific activities and services where we sought views from stakeholders on the appropriate approach – which we consider in more detail below:

- demand-side water efficiency services;
- customer-side leak repairs; and
- developer services.

2.1.1 Network calls

We had already considered the potential for additional coordination costs when making our proposal to include network calls in retail. Our view remains that the benefits to customers from a single point of contact outweigh any additional costs, and we have not changed our view on the appropriate approach to network calls.

We recognise, however, that there is a significant trade-off here. On the one hand, having networks that hear from customers directly when problems occur can be very helpful in ensuring a customer-focused service. On the other, having a strong retailer might be a more effective way of challenging the network on behalf of the customer.

On balance we have decided to include network calls and their associated costs in the retail price control because we favour the latter, and because of the benefits from a single point of contact.

2.1.2 Metering

We accept the point made, and have amended our definition of retail activities to include a role for retailers in informing wholesalers of the additional costs of serving metered customers. However, we confirm that the costs of the metering assets will remain in the wholesale control as well as any costs associated with the installation and maintenance of metering assets. Costs of meter reading will sit in the retail price control.

For non-household retail, wholesalers will need to engage with both their own retail arm and any new entrants. The role of retailers will need to be defined in market rules or 'codes' with appropriate obligations placed on non-household retailers (including new entrants). We will seek recommendations from the Open Water programme (see section 7.4 for details on the Open Water programme) to help define these obligations, including around metering. We will set out more detail on these issues in our forthcoming governance and level playing field discussion.

For household retail, companies will only be engaging with their own retail arms. But to ensure our price controls properly reflect the activities carried out by retailers and wholesalers, we still need to set out clearly the role of retailers. For consistency, household retailers will have the same obligations and duties as non-household retailers.

2.1.3 Demand-side water efficiency services and customer-side leak repairs

We explained in our methodology consultation that our preferred approach was to include both demand-side water efficiency services and customer-side leak repairs (as well as their associated costs) in retail, but with a role for wholesalers in determining the efficient level of activity and the opportunity for additional investment in these activities to be recovered through the wholesale price control.

There were mixed views from respondents. Some companies were in favour of including these activities in retail, and argued that the retailer should have a direct relationship with the customer for these key services. Those in favour of including these activities in wholesale or splitting it between wholesale and retail considered that it is the wholesaler who contracts to provide this service and may not contract with the retailer.

Both demand-side water efficiency services and customer-side leak repairs are customer-facing activities, and we remain of the view that they are best carried out by the customer-facing part of the business. Retailers will have strong incentives to reduce customers' bills, including their overall wholesale charges through demand management and customer leak repairs. Indeed, this is the experience in the Scottish water market.

These services also have the potential to contribute to maintaining the supply-demand balance. Both retail price controls will include an allowance for some costs for this activity – either based on the lower of the average provision of this activity or the actual current costs under ACTS, or the existing provision of this activity by companies under the default tariff. But companies will also be free to propose more activity and investment in this area as part of their wholesale plans – where they have customer support to do so – and contract this work to the retailer or some other party, which may require a contractual relationship to be established between the wholesaler and the retailer or another party.

So we consider that allocating these activities to retail is the right approach and we are confirming the position set out in the methodology consultation: these activities are included in retail – with a role for the wholesale business in determining the efficient level of activity.

We see the maintenance of supply and demand in each company's area and the development of water resources management plans (WRMPs), including associated demand-side measures, as remaining a core function of the wholesaler, in line with the obligations currently placed on incumbent companies.

As with metering, we need to clearly define the roles carried out by retailers and wholesalers. Here, we think retailers (including new entrants) will have strong incentives to assist the wholesalers in the maintenance of supply/demand balance in their areas anyway but these may need to be codified in some way. These will need to be defined in market rules, and we will seek recommendations from the Open Water programme to help define them.

2.1.4 Developer services

We explained in our methodology consultation that our preferred approach was to split developer services between wholesale and retail, with customer-facing activities and costs in the retail price control, and the provision of connections in the wholesale price control.

A number of companies opposed including customer-facing developer services in retail, arguing that the purpose of developer services was more closely aligned with wholesale services. Others, as well as customer groups and representatives, acknowledged the need for a more customer-focused approach to developer services.

A number of respondents also commented that splitting developer services activities would be complex, and create an unnecessary interface which would increase costs with inadequate associated benefit to companies or developers.

In reaching our final position, we have considered the additional evidence provided by stakeholders in response to the consultation. We have also carried out more detailed analysis of the approach taken in Scotland – where the equivalent activity is now part of retail having previously been part of wholesale – insofar as the retailer arranges for the connection on behalf of the developer, and may arrange for an accredited connection provider other than Scottish Water to carry out physical connections (even though the costs of connection remain in the wholesale price control).

We have considered and assessed three possible approaches to developer services: splitting between wholesale and retail; including all developer services in retail; and including all developer services in wholesale.

Our view is that including all developer services in wholesale would be simple, but it would allocate a customer-facing activity to the wholesale business. Wholesalers are not customer facing, and would have weak incentives to provide a good service. We think allocating developer services to wholesale is unlikely to deliver the strong customer-focused approach we want and that there may be on-going risks to competition in this area as well with this approach.

Splitting services between wholesale and retail would allow retailers to focus on customer-facing activities and wholesalers to focus on providing physical connections. But it would reduce transparency, particularly for activities and services near the retail/wholesale boundary and wholesalers may still have weak incentives to provide a good service unless there is some role for the retailer in driving the connection for the customer in a timely and efficient manner.

Including all services in retail – as in Scotland where the retailer has responsibility for both the customer facing service and ensuring that the physical connection is provided in a timely and efficient manner, but the wholesaler is still responsible for providing that connection and the costs of that connection still sit within the wholesale price control, would encourage a more customer-focused approach.

In Scotland, despite the costs and responsibility for such activities sitting within the wholesale price control, there is a range of accredited providers that a retailer can go to in order to seek a connection on behalf of the customer. This ensures that developer customers benefit from the simplicity of a single point of contact – the retailer – to manage all interactions with the water and wastewater providers, and that there are strong incentives to ensure that a timely and efficient connection service is provided to the developer.

In the light of our assessment, we have decided to mirror the position in Scotland and give retailers the responsibility for all the customer-facing activities with associated costs allocated to the retail price control and responsibilities and costs for connection remaining in the wholesale price control. We would envisage moving to a set of arrangements similar to the Scottish model over time, with input from the Open Water programme, so retailers could choose who undertakes the connection from a list of accredited providers.

2.1.5 Retail definition – confirmed position

Taking account of the decisions made in sections 2.1.1 to 2.1.4 above, we summarise our confirmed position on retail definition. We provide a more detailed explanation of our confirmed position (which is consistent with the definition of retail activities set out in Regulatory Accounting Guideline 4.04) in the business planning guidance.

Table 1 Retail definition – confirmed position

Activities and costs included in retail	Customer services including: • billing, • payment handling, • remittance and cash handling, • vulnerable customer schemes, • network and non-network customer enquiries and complaints Debt management and doubtful debts Meter reading Other operating costs including: • decision and administration of disconnections and reconnections;

	• demand-side water efficiency initiatives; • customer-side leaks; • other direct costs; • general and support expenditure; • scientific services; and • other business activities Developer services • providing developer information; and • administration for new connections Local Authority rates
Activities and services not included in retail and instead included in wholesale	Meter ownership Trade effluent compliance monitoring Disconnections and reconnections (physical activity) Meter installation, maintenance and replacement – but a role for retailers in determining meter functionality and capability

2.2 Wholesale controls

We explained in our methodology consultation that our preferred approach was to set separate binding wholesale controls for water and for wastewater services – and that both wholesale controls should continue to be linked to RPI in line with companies' updated licences.

Respondents generally agreed with both these aspects of our proposals. This is also reflected in the work we have carried out with companies – in parallel with the development of our methodology – to agree the changes to their licences that will be needed to set separate wholesale and retail controls.

Our final position, which aligns with the agreed changes to companies' licences, is that:

- we will set **separate binding wholesale controls for water and wastewater**; and
- both wholesale controls will **retain the existing link to RPI**.

We also consulted on the more detailed aspects of the form and scope of the wholesale price controls, which we now discuss in turn.

2.2.1 Form and scope of wholesale controls

In the methodology consultation, we proposed to set wholesale controls that limit each company's wholesale water and wastewater revenues (total revenue controls). This form of control is different from the approach we have used in the past – where we set limits on average charge increases. Respondents generally supported this approach and we are now confirming it, subject to some clarifications on the detailed specification of the price controls.

We explained that our preferred approach was for the water and wastewater wholesale controls to cover all revenues from wholesale activities, including two types of charges that we had previously excluded from the general retail price cap:

- wholesale charges for large customers using more than 50Ml of water a year; and
- connection charges, including infrastructure charges.

Respondents, on the whole, supported the broad principle of including all wholesale charges within wholesale controls – including charges for large customers and customers currently charged under special agreements – and we confirm this is our approach.

Some companies highlighted that connection charges were not treated as revenue in their own regulatory accounts and questioned whether we were seeking to mandate that all charges should be treated as revenue.

We have previously reflected different companies' different accounting treatment of connection charges in the way we have set price controls, so that affected developers effectively pay for expenditure on new infrastructure directly, instead of the company including that expenditure in its RCV and recovering it from customers over time.

We do not want the form of the price control to dictate the accounting treatment of infrastructure and connection charges; to the extent that we need to consider these issues this should be part of our work on the structure of charges and associated regulatory financial reporting. But we also want the price control to reflect the revised wording of company licences – which suggests that these charges should be within the scope of the price control.

To address these issues, we are proposing a change to the approach we set out in the methodology consultation. Wholesale controls (for both water and wastewater) will put an overall limit on revenue from charges and any cash receipts from connection and infrastructure charges. We will do this by setting wholesale controls as limits to the sum of:

- revenue from charges; and
- relevant capital contributions.

This approach means we will deduct the expected capital contributions when assessing companies' allowed wholesale costs (as we have done at previous price reviews). We will also continue to take appropriate account of any other cash or revenue accruing to the wholesale businesses, in addition to revenues and cash deriving from connection charges, in calibrating price controls. This will continue to be part of our '**single till**' approach to price control regulation, which we confirmed in 'Future price limits – statement of principles' and is an approach used by other regulators in setting price controls. We will set out the detail of these calculations in our draft determinations.

In setting connection charges we would expect companies to continue to ensure that pricing is cost-reflective and non-discriminatory and comply with all their obligations under competition law.

If a company increased revenue by unduly reducing connection charges we may take corrective action to ensure that companies returned these monies (with financing costs) to customers. Similarly, although we have decided not to allow automatic adjustments to allowed revenues for demand variations in wholesale controls, if demand for connections is unexpectedly high then we would nevertheless consider allowing extra revenue to compensate for the loss of price control revenue on a case-by-case basis.

2.2.2 Other aspects of the form of control

In the methodology consultation, we explained that there may be a case for making adjustments to companies' wholesale revenues to account for differences in demand and revenues. In particular:

- For the water wholesale control, we proposed to apply an annual **'change factor'**, which would correct companies' allowed water wholesale revenues to reflect the costs of providing more (or less) water and more (or fewer) metered connections than we assumed when we set their controls. We did not propose to use a 'change factor' for the wastewater control, because we felt there was insufficient evidence of a link between demand and costs.

- For both wholesale controls, we proposed to allow companies **flexibility to adjust charges** to correct for differences between their allowed wholesale revenues and their actual collected revenues in the previous year.

Respondents views on the need for 'change factors' were mixed. They mostly agreed with our analysis in principle, but some companies also explained that current information suggests only a modest relationship between costs and demand within a price control period – and so a change factor would be unnecessarily complex.

In the light of this feedback, our view is that we do not have sufficient evidence at this time to introduce a change factor for demand in either wholesale control. We may revisit this decision at future price reviews, as we would expect that over time companies will have better information available on costs and cost drivers (for example, as a result of the initiatives to reveal information about companies' networks discussed in chapter 11).

By contrast, respondents strongly supported greater flexibility to adjust charges to correct for differences between their allowed wholesale revenues and their actual revenues. Companies noted this would give them more flexibility to manage unexpected changes in revenue and to smooth prices over the longer term, avoiding sudden bill changes. Companies also noted that an overly-prescriptive or mechanistic approach could reduce these benefits.

We agree with respondents' views about the benefits of allowing companies more flexibility to change charges and so manage their revenues within price control period. However, we also need to put in place sufficient safeguards to protect customers from excessive bill instability, and to prevent companies from misusing this flexibility to transfer revenue between years to suit their own interests rather than those of customers. So we will allow companies more flexibility, subject to appropriate constraints (and compliance with our charging principles) which we will consult on as part of draft determinations in 2014.

We will incentivise compliance with these constraints by using a revenue correction mechanism (RCM) at the next price review to 'true up' actual revenues with allowed revenues over 2015-20. This is broadly consistent with the approach we have used in the past.

We would expect companies to use this flexibility to manage revenues appropriately during the price control period, both to ensure bill stability for current customers and also so that future customers will not face significant price disturbances.

So, we would expect any corrections made using this RCM to be NPV neutral – provided companies operate within the constraints we specify in their final determinations. Nonetheless, consistent with the approach used in other regulated sectors, if companies were to breach the constraints discussed above then (in calculating the revenue correction) we would adjust upwards refunds to customers by using a relatively high rate of interest to protect the interests of customers. The intention would be to incentivise compliance with the constraints and properly compensate customers for any overcharging.

At future price control reviews we may want to adopt a more flexible approach with these adjustments made by an annual correction factor fully integrated into the price control, which would ensure more timely adjustments to regulated revenues. This would be more consistent with the approach used in other regulated sectors.

2.3 Household retail controls

In the methodology consultation, we explained that our preferred approach to household retail controls was to:

- set a total revenue control for each company, based on the efficient costs of retail activities (as measured by the adjusted average cost to serve) and projected customer numbers;
- apply an annual change factor to cope with unexpected changes in the numbers of connected household premises – adjusting companies' allowed revenues to reflect differences between actual and expected customer numbers and levels of metering; and
- allow companies flexibility to adjust charges to reflect differences between their allowed revenues and actual collected revenues.

Respondents did not comment specifically on these elements of our proposals. We remain of the view that a total revenue control with an annual adjustment mechanism is the most appropriate form of control.

Our approach to setting the household retail control (the ACTS) explicitly acknowledges that both the total number of customers served and the number of metered customers are key drivers of efficient retail costs. This relationship is well-established, so – in contrast to wholesale controls – we think there is a strong case for using a 'change factor' in the household retail control.

We have therefore decided to apply an annual 'change factor' to the household retail control, which adjusts allowed household revenue to account for differences between actual and assumed customer numbers and levels of metering.

In line with our approach to wholesale controls, we will allow companies flexibility – within constraints specified in the final determinations – to adjust charges to minimise any differences between allowed revenues and actual collected revenues over 2010-15. We will also use an RCM at the next price review to 'true-up' actual revenues with allowed revenues over 2015-20; adjustments made using this RCM will be revenue neutral if companies comply with our specified constraints.

We explain how we will set the household retail control – including how the change factor works – in more detail in chapter 6.

2.4 Non-household retail controls

In the methodology consultation, we confirmed that we would use a 'default tariffs' approach to setting non-household retail controls.

We also explained that we had two important choices to make about the form of non-household controls.

The first choice is about how to set these non-household controls. We could choose to set non-household controls using:

- a 'total tariff' approach, where we limit the total tariffs charged to non-households – including both wholesale and retail charges; or
- a 'gross margin' approach, where we limit tariffs for non-household retail services only, with wholesale charges limited separately in line with the wholesale controls discussed above.

The second choice relates to how we should limit companies' non-household retail revenues. We could choose to set a limit on the:

- total non-household revenue each company can recover (a total revenue control – as with the household control); or
- average revenue per customer for each customer type (average revenue controls).

2.4.1 Total tariff or gross margin?

Our preferred option in our methodology consultation was to use a gross margin approach for setting non-household controls. This is because under a total tariff approach we would need to re-specify the default tariff every time wholesale charges changed (potentially every year) – creating a significant regulatory burden that is avoided under a gross margin approach.

Respondents did not comment specifically on this element of our proposals. We remain of the view that a gross margin approach is likely to be the most effective and proportionate option. We are therefore confirming the approach we proposed in the methodology consultation, and will set default tariffs using a 'gross margin' approach.

2.4.2 Total or average revenue controls?

Our preferred option in our methodology consultation was to use average revenue controls (a limit on average revenue per customer, per customer type) – as total revenue controls could blunt incentives to compete for customers, and result in significant price changes. We also note that, in Scotland, the regulator sets average revenue controls.

Most respondents supported an average revenue control but some companies raised concerns about this – for example, the risk that competitors will aggressively target lower-cost customers, leaving incumbent companies serving the remaining higher-cost customers.

In addition to the two options of average or total revenue controls set out in the methodology consultation, we have also considered a third: setting no controls, and allowing the market to determine prices for all tariffs.

Setting no controls is a simple deregulatory approach that is easy to implement, and imposes no information burden on companies. However, our view is that setting no controls would provide insufficient regulatory protection for non-household customers, particularly ahead of market opening in 2017.

Setting total revenue controls secures financeability for companies in a contestable market, but it also offers limited protection for customers and blunts the incentives on companies to be competitive or efficient. If a company loses customers to a competitor, it can simply raise prices for its remaining customers to make up any revenue shortfall.

Under average revenue controls, poorly performing companies lose revenue if they lose customers to competitors – providing effective protection for customers and incentivising competition and efficiency. Our view is that setting average revenue controls is the most effective approach for 2015-20. It ensures that companies have strong incentives to deliver efficiencies and compete for customers, and also provides an appropriate level of protection to customers while the competitive market develops.

We are therefore confirming the approach we proposed in the methodology consultation, and will set average revenue controls – limits on the average revenue per customer for each customer type.

3. Proportionate regulation

3.1 Overview and key decisions

Overview of our approach

In 'Setting price controls for 2015-20– business planning expectations' (our business planning consultation), we set out how, in line with our future price limits principle of 'ownership, accountability and innovation' we intended to make **a step change away from a prescriptive approach** to business plans.

We are now confirming our new approach, which **places the onus on company Boards to own and be accountable for plans**. We have not issued detailed and prescriptive guidance explaining how companies should structure or present their business plans. Instead, we focus on creating strong incentives for companies to submit high-quality plans and on company Boards to ensure appropriate governance and ownership of those plans.

While we confirm our approach of not giving detailed guidance on business plans, we recognise that it is helpful for us to make as clear as possible what we consider the general qualities of a high-quality business plan would be, so we have set out more detail building on the description proposed in our business planning consultation.

We want each company's Board to **own and be accountable for the business plan** they submit for PR14. This is consistent with our wider policy set out in 'Delivering proportionate and targeted regulation – Ofwat's risk-based approach'. To be considered alongside the tests, we will require that **whole company Boards provide assurance** that their plan is a high-quality plan.

In addition to the assurance that the plan is high quality, each company Board also needs to explain the governance processes of the Board – and demonstrate how it has provided strategic leadership, a transparent process, and compliance with the relevant licence conditions and the 'UK Corporate Governance Code'.

We confirm our approach to implementing **a risk-based review** containing **reputational, procedural and financial incentives** for companies' Boards to produce high-quality business plans.

Our risk-based review will contain tests for high quality in four key areas.

- **Outcomes** – the company's key proposed deliverables for consumers, including current and future customers and the environment, and the incentives associated with delivering them.

- **Costs** – the costs, for both wholesale and retail businesses, associated with delivering the company's proposed outcomes.

- **Risk and reward** – how the company's proposals balance risk and the rewards for bearing those risks between consumers, including current and future customers and the environment, and the company and its investors.

- **Affordability and financeability** – the impact of the company's proposals on customers' bills, and its ability to finance its functions.

For each part of our assessment, we propose to test companies' business plans against a number of different key assessment criteria. In most cases, we propose to carry out **separate tests for each element of companies' business plans** (household retail, non-household retail, water wholesale and sewerage wholesale), but there are some cases where we will **also apply tests at a whole-company level**.

We appreciate that, in order for companies to strive to pass **the high bar for the enhanced category**, they need to believe that they have a realistic prospect of obtaining the rewards on offer. That is why we make it clear that **a very high-quality plan will secure enhanced status**, and will not fail to do so because of technicalities in the way we apply our tests.

3.2 Delivering a proportionate price review process

In the business planning consultation, in line with our future price limits principle of 'ownership, accountability and innovation', and feedback from the Gray review and other stakeholders, we said we wanted to:

- stop issuing detailed and prescriptive guidance explaining how companies should structure or present their business plans – and instead place the onus on companies to own and be accountable for their plans;
- focus our challenge and scrutiny of companies' business plans where it is most needed – and where we can deliver the greatest benefits for consumers, including current and future customers and the environment; and
- introduce an incentives-based price review process, creating a strong package of reputational, procedural and financial incentives for companies to submit a high-quality business plan.

To deliver on these goals, we proposed to put an assessment of business plan quality – the **risk-based review** – at the heart of the price setting process. That assessment would then determine the **incentive rewards** that companies receive, and the nature and extent of our scrutiny and challenge.

3.3 A high-quality business plan

We explained in our business planning consultation that we wanted to bring about a significant cultural change in the business planning process. We wanted to move away from companies being overly focused on meeting tightly specified regulatory guidelines, and instead place the emphasis on companies developing plans that deliver for consumers, including current and future customers and the environment, in the long term.

Consequently, we said that we did not intend to set out a 'tick box' list of what a business plan should include, nor set out assessment thresholds for our tests in advance – or provide detailed information that might allow companies to estimate them.

Respondents supported in principle our proposed description of a high-quality plan, but several companies were concerned about the lack of detailed standards inherent in this approach. Concerns were expressed that, in not knowing what to aim for, companies would adopt a risk-averse approach or would provide too much information.

While we confirm our approach of not giving detailed guidance on business plans, we recognise that it is helpful for us to make as clear as possible what we consider the general qualities of a high-quality business plan would be, so we have set out more detail building on the description proposed in our business planning consultation.

A high-quality business plan:

- is designed to deliver good outcomes for current and future customers and the environment;
- has a coherent narrative based on sound reasoning and contains proportionate evidence;
- will ensure that a company meets its statutory obligations and enables the relevant regulators to confirm this in the CCG report;
- is based on good-quality engagement with customers and consumers, and the results of this engagement are reflected in the proposed outcome commitments, and the plan more generally;
- is cost efficient, containing accurate projections and estimates;
- proposes a reasonable balance of risk and reward between customers, investors, and other stakeholders, with efficient proposals to share 'pain and gain' with customers;
- is both affordable and financeable;
- comes with a high level of assurance – in the form of a statement from the company's whole Board that the plan is of a high quality, will ensure that it meets its statutory obligations, and that estimates and data have been arrived at appropriately, and independently of other companies and competitors; and
- does not seek to game the regulatory process in any way.

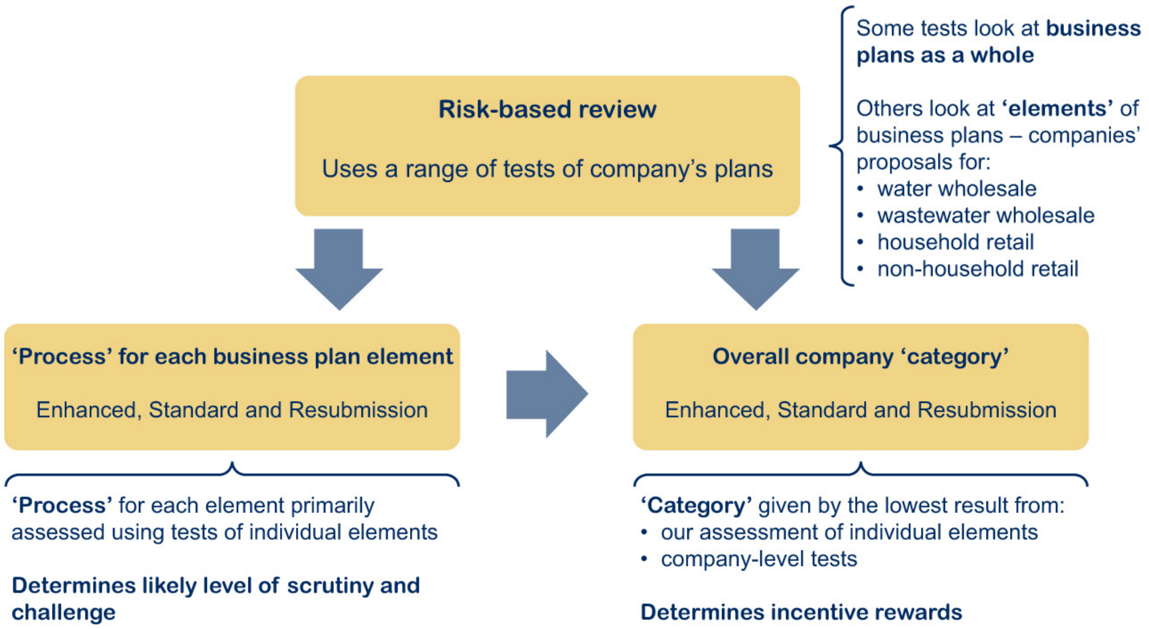
We acknowledge that this approach removes some of the certainty that companies' Boards previously had when preparing their business plans. However, we feel there is considerable merit in introducing a change that will support companies in becoming genuinely more engaged with their customers and in taking ownership of their business plans.

3.4 Assessing business plan quality – the risk-based review

In the business planning consultation, we explained that we intended to use a risk-based review to assess business plan quality.

We also set out our preferred approach to the risk-based review (see figure 3).

Figure 3 Preferred approach to risk-based review in business planning consultation



Alongside our preferred approach, we consulted on three possible variations:

- no formal 'resubmission' category;
- no 'resubmission' process for retail elements; and
- allowing companies to qualify for some incentives based on our assessment of individual business plan elements.

Respondents supported our general approach to, and process for, assessing business plan quality and we now confirm our general approach. However, a number of respondents raised concerns about individual aspects of our proposals, which we discuss in the next sections.

3.4.1 Resubmission categories

The majority of companies, and CCWater, supported our approach. There were, however, some companies who supported dropping the 'resubmission' category, or dropping the 'resubmission' process for retail elements of plans, with a key argument being that the threat of penalties, from a 'resubmission' categorisation, could drive a more risk-averse approach to business plans

We understand the concerns raised, but are not persuaded that a company which challenges itself to achieve an 'enhanced' assessment runs a significantly greater risk of receiving a resubmission 'assessment'. The risk-based review is not intended to penalise genuine aspiration and attempts at innovation – and we are confident that our tests can distinguish between genuine innovation that misses the mark and poor-quality business planning.

And we conclude that incentives for high-quality plans, in particular reputational incentives, are made stronger by the prospect of companies with plans that fall short, and are not of a good quality, being placed in a resubmission category.

For our assessment of retail elements, some companies argued for dropping the 'resubmission' process on the grounds of proportionality – as retail elements are likely to be simpler and easier for us to revise under the standard process. In addition, some companies expressed the view that it could be disproportionate to assign a company to the 'resubmission' category on the basis of serious shortcomings in a retail plan element alone.

We have considered these points carefully, but conclude that the quality of companies' retail plans is important to customers, and dropping the 'resubmission' process would reduce the incentives for acceptable retail plan elements. A company competently aiming for a high-quality retail plan should have a low probability of that plan being assessed as 'resubmission'. We have therefore decided to retain the option of a 'resubmission' process for retail elements.

3.4.2 Access to rewards for enhanced category

A majority of companies felt that our preferred approach to accessing rewards for a high-quality plan might make it too difficult, or too uncertain, for companies to obtain an 'enhanced' category assessment – and that companies might not therefore strive for an 'enhanced' assessment.

Company respondents raised particular concerns about requiring an 'enhanced' assessment for all business plan elements, and for the company as a whole, in order for the company to access financial and reputational incentive rewards for high-quality plans. Alternative suggestions included determining overall company categories using a weighted average assessment, or allowing some incentives to be awarded based on 'disaggregated' assessments of individual elements of plans.

We have considered carefully whether we should make changes to our approach to make it easier for companies to access reputational and financial rewards.

The advantage of a weighted (or disaggregated) approach to rewards is that it could improve companies' chances of gaining at least a partial reward for their proposals. This could head off concerns that a high-quality plan could miss out on any rewards 'by accident', and might make companies more likely to strive for an 'enhanced' assessment – improving the overall quality of business plans.

But a weighted or disaggregated approach to rewards would also weaken incentives for companies to produce business plans that are high-quality in all elements – including for the retail element which is critically important to customers. It would increase the scope for, and potential rewards from, being selective over which plan elements to take seriously – as companies might access rewards for parts of their plan while submitting poor proposals for others.

On balance, we are not satisfied that the benefits of a weighted or disaggregated approach to incentive rewards outweigh the potential risks and complexity. At the same time, we think we can – and should – take steps to increase companies' confidence that a high-quality business plan would access incentive rewards and not inadvertently fail our tests.

We remain of the view that there should be a high bar for companies to receive an enhanced category assessment (and the associated incentive rewards). At the same time, manifestly high-quality plans should receive an enhanced category assessment – and should not fail to do so because of technicalities in our tests. We will be guided by this overarching objective when applying our tests – and assigning overall company categories.

Conversely, where a plan has serious shortcomings, such that consumers' interests are best served by asking the company to rework elements of the plan, we remain of the view that the plan should be assigned to the resubmission category and returned to the company for more work (rather than the regulator undertaking to revise the plan). In addition, if a standard category company fails to provide sufficient information to allow us to have a productive dialogue about the revisions it should consider, then we will re-grade that company – assigning it to the resubmission category.

We have also clarified our approach to a number of risk-based review tests, with a focus on tests of the two retail plan elements (which we set out in more detail in chapters 6, 7 and 9 below).

3.5 Incentives for high-quality plans

In the business planning consultation, we set out a complementary suite of incentives designed to encourage companies' Boards to submit high-quality plans, including:

- publishing our assessments of overall business plan quality as early as is practical to do so creating **reputational incentives** – our proposals should give a clear signal to investors and other stakeholders to allow them to identify those companies that have – or do not have – high-quality plans;
- tailoring our approach to scrutiny and challenge according to our assessment of the quality of the elements of companies' plans creating **process incentives,** focusing regulatory effort where it is needed and reducing costs with:
  - '**enhanced**' elements being accepted in the round – and substantially unchanged for draft determinations. Acceptance in the round does not rule out some adjustments being required, for example, in light of the whole company assessment, or any revisions to other non-'enhanced' plan elements, or adjustments to take account of industry-wide aspects of the price review;
  - '**standard**' elements facing standard scrutiny – and, where necessary, some adjustments being made by companies for draft determination. There is likely to be some variation in the scrutiny required for standard elements but regardless, our approach it to always look to the company to revise aspects of plans, rather than for us to adopt the responsibility to do so; and
  - '**resubmission**' elements would be returned to the company to be reworked – and would face more intensive scrutiny and challenge;

- tailoring the process for setting price controls according to our assessment of overall business plan quality – including early draft determinations for enhanced companies and potentially the option of early final determinations to deliver **procedural incentives**; and
- **financial incentives** for 'enhanced' category plans – enhanced category companies will have access to enhanced menus with greater shares of cost outperformance, and will be better off overall than companies in the standard category.

We also consulted on one specific variation within this approach – publishing early assessments for 'enhanced' companies, but delaying decisions (and their publication) on the categorisation as between standard and resubmission. Any delay could not be more than a few weeks in order to give time for reworking and resubmission of business plan elements.

Respondents generally supported our high-level approach of providing incentives for high-quality plans – but commented on several aspects of our proposals. Comments included:

- several companies supported delaying decisions on a standard/resubmission categorisation to allow more time for engagement between the company and Ofwat, while others favoured early decisions to give more time to rework plans if required;
- more detail needs to be given on the financial rewards for 'enhanced' plans to encourage companies not to take a risk-averse approach and aim only for a 'standard' assessment; and
- some companies also suggested that an additional incentive for companies with 'enhanced' plans would be an early final determination, in addition to the early draft determination we proposed.

We discuss these points in the next sections.

3.5.1 Timing of resubmission decisions

Our preference remains to take decisions on resubmissions as early as possible and practical, and we confirm we will publish the results. This will enhance reputational incentives and will allow more time for companies to rework (and for CCGs and us to reassess) plans. But, when we set out our detailed timetable for the relevant phase of the review, we will pay close attention to the balance between making early decisions, and taking sufficient time to ensure our decisions are robust.

3.5.2 Benefits for enhanced companies

We recognise that providing more early clarity on the scale of potential financial rewards associated with categories could strengthen incentives for high-quality plans. However, we consider that the risks of setting financial rewards before we have information on companies' business plans – particularly on affordability and financeability – cannot be justified.

Many of the benefits for achieving enhanced status are already clear. These benefits include benefits from an enhanced reputation – a number of stakeholders, particularly investors, have told us that they put significant weight on Ofwat's assessment when they themselves assess companies. An enhanced category would give a clear signal to investors and other stakeholders that allows them to identify those companies that have high-quality plans and those companies can expect to benefit from this.

Enhanced companies can also expect lower costs from a reduced regulatory burden, reduced scrutiny of very high-quality proposals, and benefit from advantageous procedures such as early draft determinations and the possibility of early final determinations.

Although we are not currently setting the financial incentives, we confirm that – in line with our consultation proposals – companies in the 'enhanced' category will have access to enhanced menu rewards which are likely to include greater proportions of retained profit from cost outperformance. Our intention is that companies in the enhanced category will be better off overall (taking into account all relevant factors) than companies in the 'standard' and resubmission categories.

We agree with respondents that providing an option of an early final determination could boost the procedural rewards for 'enhanced' category companies – through early regulatory certainty – and that this could be achieved at no cost to customers.

However, we will need to consider carefully whether an option for early final determination can be accommodated within the overall price review process and timetable, and would be in the best interests of all parties. We will also need to ensure it would be compatible with – for example – the way we implement menus and our approach to setting the household retail control.

Taking account of the feedback we have received, we confirm that we will use the package of incentives for high-quality plans set out in table 2.

Table 2 Incentives for high-quality business plans

Reputational incentives	We publish our assessments of business plan quality as early as is possible and practical
Procedural incentives	Scrutiny and challenge of companies' proposals tailored to assessment of quality of elements: • 'enhanced' elements are accepted in the round – and substantially unchanged for draft determination; • 'standard' elements face greater scrutiny – and companies may need to do some revision for draft determination; and • companies must rework 'resubmission' elements – and they will face the most intensive scrutiny.
	Companies with 'enhanced' plans receive early draft determinations – and potentially the option of early final determinations
Financial incentives	Companies with 'enhanced' plans have access to enhanced menus – with greater shares of cost outperformance – and are better off overall

As we confirm our detailed timetable for each phase of the price review we will aim to advantage 'enhanced' companies as much as possible including, if feasible, providing an option for an early final determination.

3.6 The risk-based review in detail

We explained in our business planning consultation that our preferred option was to use a staged approach to the risk-based review (see figure 4), using a range of tests which looked at the four key areas of companies' proposals for 2015-20.

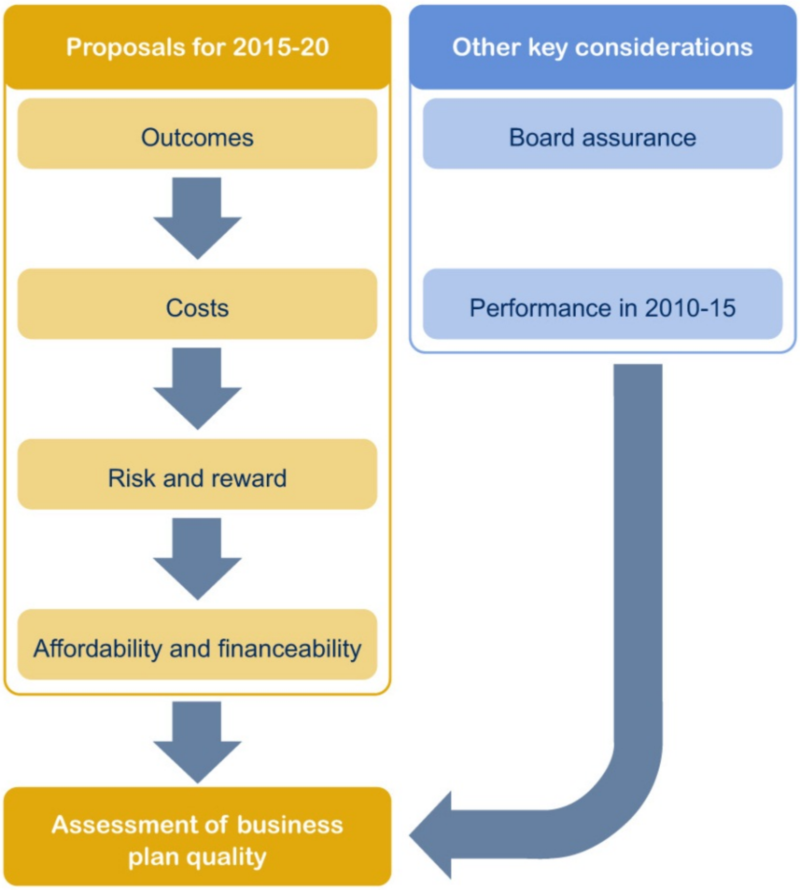
- **Outcomes** – the company's key proposed deliverables, and the incentives associated with delivering them.

- **Costs** – the costs (for both wholesale and retail businesses) associated with delivering the company's proposed outcomes.

- **Risk and reward** – how the company's proposals balance risks, and the rewards for bearing those risks, between customers and the company (and its investors).

- **Affordability and financeability** – the impact of the company's proposals on customers' bills, and its ability to finance its functions.

Figure 4 Staged approach to the risk-based review



We also explained that, alongside these tests, we would need to look at companies' **performance in 2010-15** – both to determine how differences between actual and expected performance should be reflected in prices for 2015-20 (see chapter 10 for more details), and because some aspects of past performance are relevant to the credibility of companies' plans.

For example, a company with a history of poor customer service might be expected to plan for more substantial improvements in service than a company which is already delivering better service. At the same time, a company with a poor track record of delivery might need to work hard to provide evidence to support a plan that promises a dramatic positive improvement in service.

Finally, we explained that we wanted each company's Board to **own and be accountable for the business plan** they submit for PR14 – with whole company Boards providing assurance that their plan is high quality. This is consistent with our future price limits principles and our wider policy set out in 'Delivering proportionate and targeted regulation – Ofwat's risk-based approach'. We said that we would take account of the Board's assurance statement as part of risk-based review.

The majority of respondents agreed that our proposed approach would be successful in handing back ownership of business plans to company Boards, and agreed with our high-level risk-based review tests. A significant minority of companies and environmental regulators sought more detail on how tests and assessment criteria would be applied in practice. Stakeholders also sought more clarity about the role CCGs – and other regulators – would play during the risk-based review process and beyond.

Some companies and other respondents also proposed changes and (or) additions to our tests. We have carefully considered these proposals and have made adjustments to our descriptions of the tests, or to our plans for using tests in practice, where we consider it appropriate. We also wish to be clear about the following points in relation to the risk-based review tests.

- It is our intention to assess companies' plans holistically for affordability and financeability. For a company's plan to be assessed as high quality – and gain an 'enhanced' assessment – it must be **both** affordable and financeable.

- Customer engagement is an important part of our assessment of business plan quality – and we expect plans to demonstrate they reflect customers' views, or explain where proposals do not but nevertheless have wider benefits. This is because we must also take into account the wider consumer interest, including both current and future customers and those receiving external benefits and disbenefits, for example in relation to the environment. We will take into account the evidence for whether companies' proposals are consistent with consumers' interests in all relevant risk-based review tests.

- In line with our approach of giving companies' Boards more ownership of, and accountability for, their business plans, we are placing the onus on company Boards to provide adequate assurance that their performance commitments are consistent with Defra's and (or) Welsh Government's Statement of Obligations, relevant statutory requirements and licence obligations.

- As explained in section 3.4 above, we will apply our risk-based review tests in a way which is designed to ensure manifestly high quality pass the risk-based review and secure the rewards of the enhanced category.

Overall, and in the light of the broad stakeholder support for our approach, we are satisfied that our high-level risk-based review tests are appropriate for assessing business plan quality. We have therefore decided to confirm the high-level approach to the risk-based review illustrated in figure 4. We provide more detail on Board assurance and the role of CCGs and other regulators in the risk-based review process below. We explain our approach to individual risk-based review tests – including how we have responded to specific comments on those tests – throughout this document.

3.7 Board assurance

We explained in our business planning consultation that we wanted to move away from requiring detailed independent reports and commentary on companies' business plans, and instead place the onus on companies' Boards to determine the appropriate approach to (and level of) assurance.

Respondents supported our general approach, and agreed that our aim that companies' Boards should own their business plans and agreed that our proposals (including in relation to assurance) should help achieve this.

In the light of this feedback, we confirm the approach we set out in the business planning consultation. We will not prescribe (or provide detailed guidance on) the approach companies should take to business plan assurance.

Instead, we expect companies' Boards – the whole Board, not just one or some executive member(s) – to take responsibility for signing off business plans. We also expect them to put in place any processes that they feel they need to be assured that they are submitting high-quality plans (in line with the characteristics set out in section 3.3 above).

Boards need to give us a statement, in their own words, of why they consider that all the elements (and supporting data) add up to a business plan that is high quality. For example, a Board might want to explain its assurance process (including any external assurance it used) to arrive at its conclusion that the plan is the best it can be, rather than simply asserting confidence in the plan.

In preparing their statement, Boards should also cover the specific assurances required for outcomes (see chapter 4) and performance in 2010-15 (see section 10.5) and also explain the governance processes of the Board and demonstrate how it has provided strategic leadership, a transparent process and compliance with the relevant licence conditions and the 'UK Corporate Governance Code'.

In assessing business plans, and placing companies into categories, we will take account of the nature and extent of companies' assurance – including the extent to which companies' Boards provide assurance that their plans are of high quality and convince us of the quality of that assurance.

4. Focusing on delivery

4.1 Overview and key decisions

Overview of our approach

In the past, we have made judgements on what Boards of companies should deliver. We are changing our approach so that companies' Boards:

- focus more on the **outcomes customers want**;
- **deliver for consumers**, including current and future customers and the environment, in the long term; and
- take more ownership of – and accountability for – **what they deliver**.

We have already embedded customer engagement in the business planning process. Each company and its Board now have a CCG, which will challenge:

- the quality of their customer engagement; and
- how well their proposed outcomes, associated commitments and delivery incentives reflect their customer engagement, and wider consumers' views and priorities.

We confirm our broad approach to outcomes as set out in our methodology consultation. There are three stages to the process.

- Company Boards will develop and propose outcomes and associated commitments and incentives that reflect their customers', and wider consumers', views and priorities.

- The CCG will challenge the quality of companies' customer engagement and the extent to which the business plans put forward by their Boards reflect their customers' views, and wider consumers', and provide an independent report to us at the same time as companies submit their business plans. The report may also include views from CCG, including the environment and quality regulators, on whether a company's plan will ensure it meets its statutory obligations.

- We will make the final assessment of companies' outcome commitments as part of our risk-based review of, and if necessary challenge to, companies' business plans and use the views of each CCG as a key input into this.

We want to ensure that companies' **outcome commitments** reflect what their customers want and value – so **ODIs** will need to reflect the **value** of the outcomes delivered to customers.

Where appropriate, we expect companies to put forward proposals for **both penalties and rewards**, according to the flexible framework we have set out. The proposal should include penalties if companies fail to deliver, or where performance deteriorates and, where justified by customers' WTP, rewards for outperformance. In some circumstances, it may be appropriate for companies to propose to **trade-offs between a package** of delivery commitments.

There are benefits to requiring that some outcomes are implemented by all companies – either because an incentive mechanism works on the basis of comparison between companies, or because a particular outcome is already known to be of significance to customers or the environment. We have set out two such areas.

- Since the service incentive mechanism (SIM), has successfully driven improvements in customer service during 2010-15, we will continue to use this form of mechanism for all household customers in England and Wales.

- We expect all companies to put forward a performance measure and associated ODI on leakage, and if we are consider proposals fall short, we will substitute our own incentive.

In England, we confirm that we will use the **GSS** to define the default level of service for non-household customers. This provides a backstop form of protection for non-household customers where we expect market forces to ensure that they receive a good deal.

As most non-household customers in Wales are unlikely to be able to choose their supplier, we are strengthening the protection for those customers by introducing a **separate non-household SIM for Wales**. We will consult further on the detail of this in the autumn.

4.2 Enhanced customer engagement

In the methodology consultation, we confirmed our approach to embedding customer engagement in the business planning process, with companies taking responsibility for ensuring their proposals reflect customers' views and priorities. We also explained the role of company's CCGs – independent bodies empowered to challenge both the quality of the company's customer engagement – and the way its proposals reflected that engagement, and customers' views and priorities.

We explained in our business planning consultation that CCGs' reports would be a key input to our risk-based review, and particularly our assessment of companies' proposed outcomes packages – and we confirm our approach. Because of this, we confirmed in 'IN13/06: 2014 price review timetable – deadline for business plan submission' that we would be asking CCGs to submit their reports on 2 December 2013.

CCGs have also sought further clarity on their role through the rest of the price control process – and in particular:

- whether, if a company was required to resubmit its business plan, CCGs would need to submit a further report assessing the resubmitted business plan; and
- whether CCGs would be expected to submit representations on companies' draft determinations.

We have considered carefully whether we should require a supplementary CCG report alongside resubmitted plans. A supplementary CCG report could help inform our scrutiny of resubmitted plans, and help ensure companies' revised proposals continue to take proper account of consumers' priorities. However, requiring a supplementary CCG report might create some additional burdens on CCGs and timing constraints for companies, particular if a plan needs significant rework.

On balance, we have decided that the best approach is to ask for a short-form supplementary CCG report alongside resubmitted plans that addresses the key changes in the resubmitted plan. It will be for the company and its CCG to agree how they engage in the time available for resubmission.

4.2.1 Role of other regulatory bodies

In responses to both the methodology and business planning consultation, the Environment Agency, Natural Resources Wales and Natural England all raised concerns about the need for environmental regulators contributing their views on companies' proposals and environmental obligations through CCGs. They suggested a more direct role for environmental regulators – working with Ofwat to assess the quality of companies' proposals through the risk-based review.

The environment and quality regulators have important roles. Companies must meet statutory requirements, and the regulators work with **each** company to ensure it knows its statutory requirements and has enough information to plan where requirements are currently uncertain. Companies with the best business plans will have engaged actively with their customers and stakeholders, including their environmental and quality regulators. Their plans will clearly show how they have taken current and future customers' needs into account while meeting their statutory and environmental obligations.

The independent CCGs provide new and powerful forums through which each company can engage with customers and stakeholders. Environmental regulators make vital contributions to each CCG including to make sure the CCG understands how environmental concerns, and resilience to environmental change, should be reflected in plans. And CCGs provide the forum for considering the trade-offs, beyond statutory requirements, between local environmental and other local customer priorities.

Where CCG members have different views that cannot be resolved – including in relation to environmental obligations – then the CCG report should clearly highlight these differences. We would then expect the company's business plan to clearly explain how it has sought to balance these different views.

We would also expect the environment and quality regulators to highlight in the CCG report whether a company's plan will ensure it meets its statutory obligations. Where we think, after considering the CCG report, a business plan does not meet its statutory obligations we will take that in account in the risk-based review process.

Once business plans and CCG reports are submitted, the price review moves into a new and distinct phase. For the risk-based review, we will make assessments based on those submissions which determine companies' categories – and thus how we will scrutinise their plans and the extent companies will benefit or not from the categorisation. This is a formalised process that must be robust, transparent and provide a level playing field.

After risk-based review, we will continue to work with our stakeholders including the environmental and quality regulators – specifically the Environment Agency, the Drinking Water Inspectorate and Natural Resources Wales – as we progress company plans through the price review to final determinations.

In line with the overall principles of the price review, we consider that this is the right approach to helping ensure that companies' plans and determinations are consistent with statutory requirements and effectively resolve any competing local priorities.

4.3 A tailored approach to delivery

In the methodology consultation, we set out the core elements of the price review that we will not change. We also set out an important package of changes designed to improve the way that both companies and our price setting process focus on delivery for consumers, including current and future customers and the environment in the longer term. A major part of this change is that the price control will focus on what outcomes companies intend to deliver for their consumers (including current and future customers and the environment).

4.4 An outcomes- and customer-focused approach

In the methodology consultation, we confirmed our high-level approach to regulating wholesale and household retail services, and that:

- we would adopt an **outcomes-focused approach**, with companies held to account for what they deliver for their consumers, not the way the they choose to deliver it;
- companies should develop and propose **outcomes** – and associated **performance commitments** – through customer engagement;
- companies should also develop and propose a consistent supporting package of **ODIs**;

- company Boards are responsible for listening to their customers and for the proposals they submit to us;
- **CCGs** should challenge – and report to us on – the quality of companies' customer engagement and how well they have taken account of customers', and wider consumers', views and priorities; and
- we will challenge companies' proposals where necessary as part of our risk-based review of business plans.

In our consultations we also proposed:

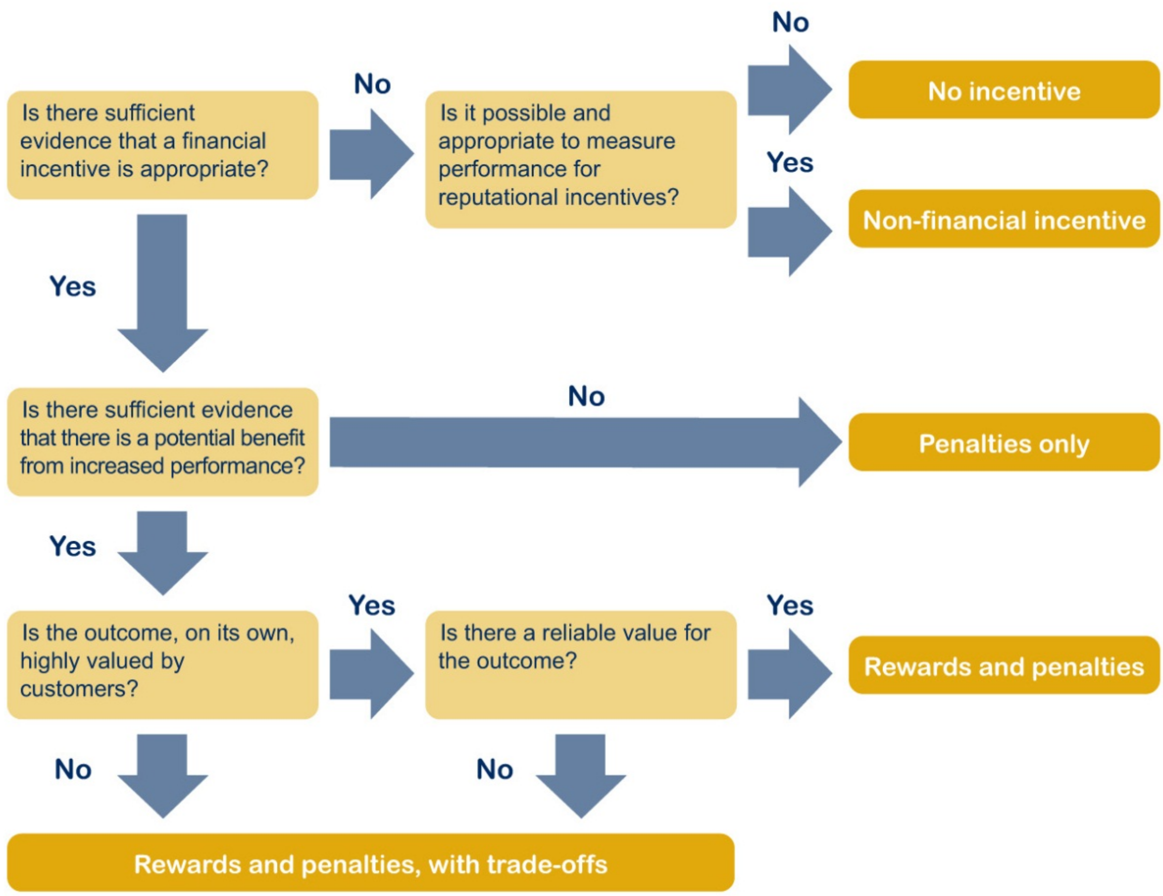
- a **flexible framework** to guide companies in making their outcome proposals;
- setting **consistent incentives**, or minimum performance levels in some areas – and invited views from stakeholders on whether we should set further **minimum standard outcomes** and associated incentives; and
- a range of tests we would use for our **risk-based review of companies' proposed outcome commitments** and associated incentives.

Respondents expressed strong support for the move to an outcomes- and customer-focused approach to delivery, particularly noting that it should improve customer legitimacy and provide companies with greater flexibility to manage delivery under changing circumstances. But they also raised a number of concerns about the detail and implementation of our proposed approach, which we discuss in the following sections.

4.4.1 Flexible framework for ODIs

In the methodology consultation, we explained that our preferred approach was that incentives should be based on the value customers place on the outcomes. We also set out a framework (see figure 5), which permits a variety of different incentive types where justified by the benefits to customers, to determine the appropriate form of incentives. We also proposed that incentives should be binding over the 2015-20 price control period.

Figure 5 Methodology consultation framework for determining incentives



The majority of respondents supported our proposed approach. However, companies did raise a number of different concerns about our proposals, which we summarise in table 3.

Table 3 Key concerns raised by respondents

	Key concerns raised
Incentives based on value	Value-based incentives may encourage companies to under-promise in their business plans to maximise outperformance incentives
Flexible framework for form of incentives	Too much emphasis on financial incentives, and too little scope for trade-offs Need to consider how outcomes fit with other regulatory incentives Companies should not set their own incentives
Incentives binding over 2015-20	Five-year commitments might incentivise short-term thinking and discourage innovative, more sustainable approaches

Our view is that companies should be incentivised to meet the needs and aspirations of their customers – and incentives that reflect value are the best way to do this. The risk of under-promising will be addressed through the work of the CCGs, our risk-based reviews and the subsequent work we will do to set baselines for standard and resubmission companies.

The framework summarised in figure 5 recognises the role of non-financial incentives. At the same time financial incentives (without trade-offs) provide the strongest and clearest protection for customers. So we continue to consider it is appropriate that companies need to justify, with evidence, where they propose either non-financial incentives or trade-offs between incentives.

Companies need to adopt a robust and transparent approach to calibrating ODIs, taking account of cost performance and other incentives (including those put in place to deliver other regulators relating statutory obligations) and should address the interactions between incentives. These matters are discussed further in appendix 1.

Allowing companies to propose their own incentives is an important part of ensuring companies' Boards own their plans and their engagement with their customers – and in this context it would be inappropriate for us to dictate incentives. We understand that company-owned incentives also carry risks to customers – we have introduced CCGs and specific tests of ODIs in the risk-based review specifically to counter this risk.

The overall regulatory framework for 2015-20 is designed to incentivise longer-term planning and delivery – one example is the use of a totex approach to wholesale costs, which should encourage companies to adopt the lowest whole-life cost solution. Companies are able to propose outcome commitments that go beyond the 2015-20 period. But, for the associated ODIs to be practical and effective, they need to be able to apply them within 2015-20. Combined with our risk-based review of companies' outcomes – which includes tests of the longer-term commitments that companies make (for instance relating to the environment, asset serviceability and the quality of service) – we think this will be sufficient to ensure companies do not focus unduly on short-term approaches.

Overall, we are satisfied that our preferred approach and framework put forward in our methodology consultation is appropriate and so we confirm the approach. We expect companies to put forward incentives based on value, binding over 2015-20, and taking account of the broad framework set out in our methodology consultation (which is summarised above).Companies should also consider the further information set out in appendix 1 on the integration of ODIs with other incentives.

4.4.2 Requiring consistent incentives

In the methodology consultation, we proposed the use of consistent incentives that all companies would have to include in their business plans. We consider that we should require companies to adopt such incentives where:

- cross company comparison is necessary for an incentive's operation;
- it may improve the quality of information available to regulators or Government; or
- a particular outcome is already known to be critical to customers or the environment.

We said that we were considering consistent outcome incentives for:

- SIM;
- AIM; and
- leakage.

4.4.3 Requiring consistent incentives – SIM

In our methodology consultation, we proposed to use a consistent incentive for household customer service by continuing to use the service incentive mechanism (SIM) that has successfully driven improvements in customer service during 2010-15, applied to all household customers in England and Wales.

We proposed that SIM scores for 2015-20 should be calculated using data from household customers only, and that we would apply financial incentives to household retail prices in a way that delivers a similar financial outcome to the current SIM.

Many respondents strongly supported the use of the SIM as a consistent incentive across all companies. Nonetheless, some companies raised a general concern that setting consistent incentives does not support company Board ownership of outcomes and incentives. We have considered this point but consider that setting consistent incentives does not prevent companies putting forward their own outcomes and incentives that go beyond our requirements.

As such, we remain of the view that it is appropriate to use the SIM as a standard minimum national incentive to drive quality of customer service for 2015-20 – and confirm our consultation proposals to do so.

To assist companies' Boards in preparing their business plans, we are also confirming the likely scale and scope of the SIM for 2015-20 will be similar to the current SIM. The SIM rewards and penalties for 2015-20 will:

- be applied to the household retail controls in England, and both retail controls in Wales;
- companies facing the same potential magnitude of financial impact that is in place for the current SIM, but focused within retail controls only.

We will consult further on our approach to implementing the 2015-20 SIM, including the design of the household retail SIM and the non-household retail SIM in Wales, in the autumn. We will also update SIM scores for year two performance at this time.

4.4.4 Requiring consistent incentives –AIM

Chapter 8 describes our approach to AIM. In summary, sustainable abstraction remains a key policy objective but we have needed to make important changes to our proposals for AIM.

Our proposal for AIM set out in our methodology consultation was to provide specified rewards (and penalties) in price limits when a company reduces (or increases) abstraction at low flows at environmentally-sensitive sites compared to its baseline historic level.

It remains our view that a national financial incentive is appropriate, but despite working hard alongside colleagues in the Environment Agency, and with companies, the data we need to set national financial incentives is not yet robust enough for us to set such incentives in the forthcoming price review. Setting national financial incentives using data that are not sufficiently robust risks exacerbating over-abstraction, rather than reducing it.

So we will **implement the AIM during 2015-20 on a powerful reputational basis**. Experience shows that companies place significant value on achieving high ranking in league tables that we set, even going so far as to link management incentives directly to them. The reputational incentive will therefore act as a powerful tool for changing abstraction patterns at the same time as allowing companies and the Environment Agency to improve the data and learn how the incentives might work when financial penalties and rewards are added.

We continue to strongly encourage companies to include within their outcomes packages outcome commitments and, as appropriate, associated financial relating to over-abstraction from environmentally sensitive water bodies where reliable local data is available. Consistent with the general approach to outcomes, we would expect any outcomes and ODIs to reflect customer preferences and WTP and to be challenged by customers and environmental stakeholders through the CCGs.

If a company set a well-designed, evidenced and stretching abstraction outcome commitment and delivery incentive, it is likely to benefit within the reputational comparisons of companies under the AIM.

4.4.5 Requiring consistent incentives – leakage

Feedback and research consistently demonstrates that customers want their suppliers to reduce leakage further, and that this is a priority service issue with which they have become increasingly concerned.

There are real benefits from reducing levels of leakage:

- more usable water could be left in the environment to benefit other users (such as farmers) or to sustain natural habitats;

- companies would need to spend less on new supplies, saving on treatment and pumping costs – and reducing greenhouse gas emissions; and
- customers may be encouraged to use water more efficiently themselves.

But there also substantial costs to controlling leakage – from materials and energy to the people needed to find and fix leaks. The benefits of reduced leakage need to be balanced against the costs of delivering it.

Like AIM, the assessment of the benefits and costs of leakage can be very locally dependent. For example, in some local areas leakage reduction could have substantial value in balancing supply and demand, allowing companies to defer large capital schemes until better evidence shows whether or not they are needed – and so reduce the pressure on customers' bills.

So we see benefits in an approach to leakage reduction that both continues to involve national reputational comparisons (like AIM and SIM), but also involves more engagement at the local level between companies and their customers to identify localised outcome commitments and delivery incentives supported by local customer WTP evidence.

Given the importance of leakage to customers, we confirm that we expect all companies to include, within their overall set of proposed outcome commitments, a commitment on leakage. They should also propose appropriate performance measures and ODIs associated with that commitment, in line with our overall approach to outcomes set out in this document, taking into account customer engagement and subject to challenge by CCGs.

In our methodology consultation we said that we would set out our proposals on leakage in a further consultation. Having considered further, our view is that as we have confirmed that a commitment for leakage is required as part of a company's outcomes package, the framework that should be applied fits within our general framework for outcomes (which we have consulted on). This general framework provides that each company should consult its CCG on its approach to outcomes (which should now include leakage).

However, since a leakage outcome commitment is a consistent outcome incentive required from all companies, we are providing some further advice on the form of leakage outcome commitments.

- In setting the outcome commitment, companies should have regard to the sustainable economic level of leakage (SELL) as developed in their WRMPs – taking account of the recommendations for improving the way SELL calculations include non-economic factors set out in 'Review of the calculation of the sustainable economic level of leakage and its integration with water resource management planning'.

- Companies must include effective evidence for their proposed outcome commitments generally, but in particular if the proposed leakage outcome commitment does not reflect an overall reduction in leakage over 2015-20, companies must include robust evidence that this is appropriate, given the views of their customers and bearing in mind that it is well established that generally water customers care strongly about leakage.

- We expect to see outcome commitments and incentives that are robust, challenging and evidence based. If our assessment, under our risk-based review, is that a company's proposed outcome commitment, performance measure and (or) delivery incentives are inadequate, then we will replace it with our assessment of the appropriate outcome commitment and incentive on leakage. We would expect to take a robust and challenging approach, including on appropriate incentive penalties, when we imposed our view over an inadequate proposal.

We also expect companies to publish their actual level of leakage (measured as total leakage, including customer supply pipe leakage) at least annually as a key performance indicator. As an additional – national – reputational incentive, we will publish comparisons of all companies' performance on leakage each year (with appropriate modifications to account for differences between companies' outcome commitments which have been evidenced by the views of their customers). We will set out details of this reputational incentive once we have reviewed companies' proposals in their business plans for local outcome commitments and incentives.

4.4.6 Requiring consistent incentives – other proposals

Some respondents proposed other areas where we could specify consistent incentives. Of the incentives proposed, only two were put forward by more than one respondent: incentivising carbon reduction and incentivising demand reduction.

There is no statutory obligation for water companies to reduce their carbon emissions but Defra's Statement of Obligations (SoO) explains that water companies should identify steps to contribute to the government emissions targets – and companies' business plans should give adequate assurance that their proposed performance commitments are consistent with the SoO.

For demand management, companies already have a statutory duty to promote the efficient use of water (section 93A of the Water Industry Act 1991, as amended). The Water Resources Management Guidelines also ensure they consider demand management as an option to balance supply and demand. Companies can also set their own proposed outcome commitments and incentives for demand management – reflecting their specific circumstances and their customers' preferences.

To maintain company ownership of performance (and performance incentives), we would only want to specify consistent national incentives where there was a compelling case to do so. We do not think that a compelling case has been made for consistent carbon reduction incentives, consistent demand management incentives, or other extensions to the scope of consistent incentives. Where there is strong local evidence supporting outcomes then companies can put forward proposals, but we see no compelling case to extend the scope of national incentives.

4.4.7 Challenging companies' proposals – our risk-based review tests

We explained in the methodology and business planning consultations that we would assess and challenge companies' proposed outcomes (ODIs) as part of the risk-based review.

As set out in chapter 3, the risk-based review will use a range of tests – including tests of outcomes – to assess the quality of companies' business plans. We consulted on those tests in the business planning consultation.

For outcomes, our proposed tests used a range of key assessment criteria to evaluate companies':

- consumer engagement;
- performance commitments; and
- ODIs.

Although most respondents broadly supported our proposed package of tests, some raised concerns about how well our tests – and the outcomes approach in general – supported long-term sustainable development and the delivery of statutory requirements (for example, in relation to drinking water quality or environmental improvements).

Some environmental regulators also noted uncertainty over the schemes likely to be required by phase 5 of the National Environment Programme, particularly in the context of the Environment Agency's ongoing work on River Basin Management Plans.

Our overall price setting framework is designed to facilitate delivery of long-term benefits to consumers – including statutory requirements. Through companies' CCGs, other regulators have an opportunity to shape companies' proposals to secure delivery of statutory requirements.

Where future statutory requirements are uncertain, we expect companies to base their business plans on reasonable assumptions about those requirements and to explain how they think the uncertainty should be dealt with in the new price control arrangements. To the extent it is practicable and reasonable to do so we will take account of any changes to requirements which arise during 2014 and develop appropriate price control mechanisms to deal with uncertainty.

To retain company ownership of business plans, we remain of the view that it is appropriate to ask company Boards to provide assurance that their outcomes are consistent with relevant obligations and statutory requirements. We will also expect the environment and quality regulators to provide their view on the consistency of companies' outcome commitments with their statutory obligations in the CCG report (this is in line with the role of other regulatory bodies that we discussed in section 4.2 above).

But – reflecting concerns about possible risks to longer-term delivery – companies will be required to demonstrate that their outcome commitments are consistent with the interests of future as well as current consumers, for example in relation to serviceability (long-term sustainability of the asset base).

When assessing a company's future plans for delivery of outcomes, we will consider its past performance – both to assess the adequacy of the company's ambition in its proposed outcome commitments, and the credibility of its plans for delivery of its proposed commitments.

The risk-based review is about assessing a company's future plans, and every company, whatever its historic performance, will have the opportunity to pass the risk-based review if its plans are of sufficiently high quality. But a company with a track record of poor performance or systemic delivery issues in a particular area may, subject to its customers' views, need to demonstrate sufficient ambition for improvement coupled with a credible action plan for delivering that improvement.

We set out our final risk-based review tests for outcomes in table 4. These tests will be applied separately to each relevant control (household retail, wholesale water and, where relevant, wholesale wastewater).

The term consumer includes both current and future consumers and those receiving external benefits and disbenefits – for example, in relation to the environment.

Table 4 Final risk-based review tests for outcomes

Test	Key assessment criteria
Consumer engagement and willingness to pay (WTP) information	To what extent has the company demonstrated an effective customer engagement process? To what extent has the company demonstrated effective engagement with wider consumer interest, including environmental interests, generally and through their CCG? [Sentence inserted 26 July 2013.] How far has the company demonstrated a robust approach to gathering willingness to pay information and in mapping this to its outcomes, performance commitments, and outcome delivery incentives?
Performance commitments	To what degree has the company given adequate assurance that its performance commitments are consistent with Defra's and (or) Welsh Government's Statement of Obligations, relevant statutory requirements and licence obligations? How reasonable are the company's assumptions in relation to areas of anticipated statutory requirements and (or) environmental programme that remain uncertain? How clearly and appropriately has the company allocated its outcome commitments between its separate controls (household retail, wholesale water and, where relevant, wholesale wastewater)? How well has the company demonstrated that its proposed outcome commitments are consistent with the interests of consumers in the longer-term (in particular that its activities and outcomes will be economic and efficient in the longer term)?

	How consistent are the company's proposed commitments with requirements specified in our methodology, including in relation to SIM, AIM, and leakage? How strong is the evidence that the company has provided in relation to its previous track record of delivery in relation to performance commitments and to what degree does this support its commitments for the future? To what extent has the company properly justified any changes in proposed performance levels? How well do the company's proposed commitments reflect value for money, and how reasonable are the costs? How clearly has the company demonstrated that the proposed commitments can be measured and recorded consistently and that they will have the appropriate governance and quality assurance processes in place to ensure that the proposed performance commitments will be based on robust data?
Outcome delivery incentives (ODIs)	To what extent the proposed incentives conform to the framework specified in our methodology? How well do the proposed incentives represent an appropriate balance of risk between companies and customers? How consistent are the company's proposed ODIs with consumers' interests and with customers being appropriately compensated for any under-delivery of performance commitments? To what extent the company's ODIs take properly into account its assumptions on other regulatory incentives, including totex efficiency sharing and any incentives or penalties it proposes associated with the wider statutory frameworks within which it operates?

4.5 Regulating delivery of non-household retail services – default level of service

We explained in our methodology consultation that our preferred approach to regulating service for non-household customers in both England and Wales was to use a default level of service – a minimum defined service level that companies must offer in association with the default tariff. We also explained that our preferred approach was to use existing statutory minimum standards – the GSS – to define the default level of service. We said that we would differentiate our control in Wales by ensuring that we include a specific service incentive given the fact that most non-household customers in Wales are unlikely to be able to choose their supplier.

The majority of stakeholders agreed that the GSS should be used as the default level of service. Some companies noted that using the GSS was not an ideal solution – because several standards relate to wholesale services – but agreed that adopting the GSS would be simpler than developing a bespoke service standard, particularly as any such standard would most likely be made obsolete as and where competition develops. Some companies also noted that they currently offer a higher level of service than the GSS, and suggested that each company should propose its own default level of service to match the default tariff.

We have also carried out further work looking at other possible approaches to the default level of service:

- we approve service levels for each tariff;
- companies define their own service levels; and
- no default service levels.

We do not think approving service levels for each tariff is a viable approach: the subjective nature of services is likely to make any assessment of service levels complex, and would create a disproportionate burden on both Ofwat and companies, especially where there is the prospect of a competitive market developing.

Allowing companies to define their own service levels could mean default service levels better reflect the current service that companies provide. But it would also make the non-household market more complex – as regulated service levels would most likely vary between company areas and services – and could stifle entry. Companies would also need to justify their proposed service levels in business plans – creating an additional regulatory burden.

Having no default level of service is the simplest and least burdensome approach, but it provides no protection to customers. We do not think this is a viable approach for 2015-20, particularly as most non-household customers will not have choice before 2017. In the light of both consultation responses and our further work, we remain of the view that using the GSS standards will provide a simple and effective backstop for customers, without imposing excessive burdens or preventing companies from offering a better service alongside default or other tariffs at their discretion. This is also similar to the approach used in the Scottish market.

We are therefore confirming the position set out in the methodology consultation: we will use the GSS standards as the national default level of service, but will not impede companies offering higher levels of service if appropriate to meet their customers' needs.

4.5.1 Strengthening protection for customers of Welsh companies

We explained in our methodology consultation that – because most non-household customers of Welsh companies are unlikely to be able to choose their supplier – we wanted to strengthen protection for those customers using a targeted additional service incentive.

We set out a range of possible options for this incentive – including an approach based on the SIM and an incentive that promotes service improvements in line with those delivered by the non-household retail market in England. We did not set out a preferred approach, and invited views from stakeholders on the appropriate approach.

Most respondents did not comment on this area. Those that did – including attendees at our stakeholder workshop on controls for Welsh companies – favoured using a customised non-household version of the SIM. Comparisons with service offerings in England were thought to be too difficult to apply in practice.

We have considered three possible approaches to setting a non-household service incentive for Welsh companies:

- make comparisons with equivalent service offerings by English companies;
- use the SIM, calculating a single SIM score for each Welsh company (which covers both household and household customers) to compare against household SIM scores for English companies; and
- use an incentive similar to the SIM, calculating separate a score for non-household customers of Welsh companies which can then be compared to household SIM scores for all companies.

Our view is that making comparisons with services in England has the potential to capture the dynamic benefits delivered by competition and innovation in England. However, any such assessment is likely to be too complex to implement – as service offerings will vary between companies. It will also impose a significant regulatory burden on English companies, without providing any benefits to their customers.

Including non-household customers in a combined SIM score would be comparatively simple to implement – and avoids placing undue burdens on English companies. But, because non-household customers would make up only a very small proportion of customer contacts covered by the SIM, we do not think this combined approach is likely to drive improvements in service for non-households.

Using a separate non-household SIM for Welsh companies – as suggested by some respondents – more directly targets the quality of service provided to non-household customers, but without the complexity and potentially significant regulatory burden associated with making comparisons with non-household services in England. It uses a proven effective incentive mechanism, and is also the approach supported by most stakeholders.

We recognise that this approach does not directly take account of benefits delivered by competition in England; however, there is potential for an indirect effect if Welsh non-household customers become more demanding because they are not benefiting from competition.

We have therefore decided to use a separate non-household SIM for Welsh companies. As with the household SIM for 2015-20, the scope and scale of rewards and penalties will be similar to the current SIM arrangements.

We will consult further on the detailed design of the non-household SIM for Wales, including options for addressing the sample size issues, in the autumn.

5. Securing value for money – wholesale controls

5.1 Overview and key decisions

Overview of our approach

In order to set both wholesale controls, we need to determine the appropriate revenues that companies need to collect through their water and wastewater charges – companies' **allowed wholesale revenues**.

The high-level approach we will take to setting allowed wholesale revenues is the same for both water and wastewater controls, and is driven by three inter-related policy decisions:

- how we determine the efficient level of expenditure (**cost assessment**);
- how we set incentives for companies which encourage efficient delivery and reductions in wholesale expenditure (**cost performance incentives**); and
- what proportions of that expenditure should be recovered from current – and future – customers (**cost recovery**).

We have decided to confirm our consultation proposals, and will implement a **totex-based approach** to assessing efficient expenditure for the next price review.

We are making this change to move to a totex approach because assessing operating and capital expenditure separately can lead to different incentives for companies to deliver operating and capital efficiency savings, and might contribute to a bias towards capital intensive business solutions and expenditures.

Some companies said we should make available our cost assessment models during 2013. We remain of the view that companies should focus on formulating business plans which deliver for their consumers (including current and future customers and the environment) in the long term, rather than being driven by regulatory models of cost assessment.

We intend to release the base data, including the data that will be used to calibrate our main cost assessment models, in the second half of 2013. We will be fully transparent in setting cost baselines in 2014.

Menu regulation can provide extra incentives for companies to reveal information, allows for some extra flexibility in setting totex baselines, provides some additional flexibility in setting efficiency sharing factors and allows companies to better manage risks and rewards. Since we consider that the overall timetable for the price review can be arranged to allow for the introduction of menu regulation, we intend to use menus in the price setting process.

We will set **menus as part of water and wastewater price controls** for enhanced and standard companies, with companies making choices toward the end of the price control review. We intend to publish proposed menus for enhanced companies and first drafts of menus for standard companies alongside their respective draft determinations and initial baselines in 2014.

A significant proportion of companies' wholesale expenditure comes from investment in long-lived assets. Both current and future customers benefit from that investment, and we therefore seek to ensure that both current and future customers pay a fair proportion of the costs of investment. Since privatisation, we have used RCVs to achieve this.

We are confirming our approach for **companies to propose the proportion of its expenditure to be recovered through its RCV**. We will challenge companies' proposals, where required, through the risk-based review process.

Ofwat has always set separate indicative price controls on water and wastewater activities – and these price controls have been based on an original split of privatisation asset values between the water and wastewater RCVs. Even though some of these values may no longer be accurately split between the two services we have decided not to mandate changes to the existing notional split between water and wastewater RCVs at this price review but companies should seek to put forward cost-reflective RCV splits in their business plans – provided their proposals remain both affordable for customers and financeable.

We have explained in chapter 2 that we will set two separate wholesale controls – one for water and one for wastewater – each of which will limit companies' total revenues (and capital contributions) from wholesale activities.

5.2 Cost assessment – a totex approach

In the methodology consultation, we explained that we wanted to make a significant change to our approach to assessing efficient expenditure – moving away from separate assessments of operating and capital expenditure, and towards an approach based on totex.

We explained that we want to make this change because assessing operating and capital expenditure separately can lead to different incentives for companies to deliver operating and capital efficiency savings, and might contribute to a possible bias towards capital intensive solutions.

Instead, we are seeking to develop an approach consistent with company ownership of business plans, where companies adopt solutions that are in the best interests of consumers (including current and future customers, and the environment), and other obligations of their businesses, as efficiently as possible.

Most respondents supported the introduction of a totex approach. A small number of companies suggested a totex approach could lead to a bias towards the short term and solutions based around operating expenditure.

Our view is that, over time, an approach based on totex supported by a benchmarking approach to assessing efficiency should minimise any bias to incentives across different categories of costs. This is because our approach to cost performance incentives will reward savings equally and so this will avoid bias toward either operating or capital activities provided that such an approach is retained in the longer term and a robust approach is adopted to outcomes regulation.

As part of the risk-based review we will consider whether companies' Boards have given appropriate assurance that their plans and outcome commitments (see chapter 4) reflect the importance of developing an approach to longer-term performance that properly takes account of customers' interests and their WTP for service levels.

We have decided to confirm our consultation proposals, and will implement a **totex-based approach** to assessing efficient expenditure for the next price review.

We explained in our methodology consultation that our preferred approach was to develop a fully-integrated totex approach to assessing efficient expenditure, based on top down benchmarking (using regression analysis) of water and wastewater costs. The advantage of such approaches is that they seek to identify business cost drivers and efficient levels of costs based on relatively high-level data – and so avoid difficult and burdensome assessments of companies operating practices and capital plans.

However, we recognised in our methodology consultation that there may be practical difficulties developing robust top-down benchmarking models for all areas of expenditure. Our continuing work is designed to address a number of challenges with specifying robust totex models (including in relation to wastewater enhancement expenditure).

We also said that it would be for companies to make the case for any costs that should be treated differently, either in relation to cost assessment or cost performance incentives.

A number of the respondents to our methodology consultation expressed reservations about an undue focus on individual regression models, the modelling of enhancement expenditure and whether high-level benchmarking would adequately capture regional and other special cost factors. Respondents (in particular companies) also requested guidance on how certain cost items, such as pensions, business rates and Thames Tideway costs, would be treated in our approach to cost assessment.

We have considered these concerns and issues carefully – and there are a number of areas where we now clarify and confirm our approach in more detail.

- For both water and wastewater costs we will consider a range of regression models, and, where such models are robust they will include models based on totex. In using these models as part of the risk-based review, and to formulate baseline cost estimates, we will use either an average or range of the results from different models. The broad approach to assessing cost efficiency in the risk-based review is discussed further in section 5.5.

- In the light of the difficulties in robustly modelling enhancement expenditure based on historical data we will also develop separate models of enhancement expenditure – and will consider a wider range of data and cost estimates in order to develop models that are reasonably robust. These will be complemented by regression models of base expenditure.

- Where cost estimates are based on historical data it will be necessary to make assumptions about changes in cost drivers, price and productivity levels over the period 2015-20 (in order to properly calculate the cost estimates that will support the new price controls). All companies should set out the assumptions (and the supporting evidence) that they have made on real price effects, productivity and efficiency changes in their business plans.

5.2.1 Publishing our cost assessment models

Some companies said we should make available our cost assessment models during 2013, while others stressed the importance of transparency but accepted that cost assessment models could be released after companies had provided business plans.

We remain of the view that companies should focus on formulating business plans which deliver for consumers (including current and future customers and the environment), rather than being driven by regulatory models of cost assessment. In any case, our cost assessment models will remain under development until at least the autumn, as we will want to take account of the cost information companies provide in their August submissions.

Nonetheless, we acknowledge the advantages of a transparent approach to cost assessment. We intend to release the base data, including the data that will be used to calibrate our main cost assessment models, in the second half of 2013. We will be fully transparent in setting cost baselines in 2014.

5.3 Cost performance incentives

We explained in our consultations that - consistent with our approach to cost assessment – we wanted to introduce totex cost performance incentives.

Our proposals were that these incentives would involve identifying a **baseline** level of totex and an **efficiency sharing factor** for each of water and wastewater, and so:

- for enhanced companies these estimates would be consistent with business plans (so that when taken together with the financial incentives for enhanced business plans these companies would be free to implement the commitments that they have proposed in business plans and at the same time they will receive additional financial rewards so that they should be materially better off than standard companies); and

- for standard companies we would use our cost assessment to derive a baseline level of totex, and the modelling of risks and rewards to determine appropriate efficiency sharing factors.

As we indicated in the methodology consultation, there may be some categories of expenditure which it would not be efficient or effective to subject to these general cost performance incentives. Nonetheless, we also explained that we would not wish to weaken the effectiveness of the cost performance incentives – and so in general we will only exclude items from general incentives if business plans include both compelling evidence justifying why items should be excluded and compelling proposals for how these items should instead be treated in the regulatory framework.

In their responses to the methodology consultation, a number of companies asked for specific guidance ahead of business plans on the treatment of costs items such as pensions, business rates and Thames Tideway costs.

Consistent with the approach to companies owning business plans it would be premature to provide such guidance at this stage. It is also important to emphasise it is for companies to:

- make a compelling case as to why any items should be excluded from the general cost performance incentives and provide supporting evidence; and
- set out proposals for how these cost items should be treated in the price control and how such a treatment would be fully consistent with protecting the interests of consumers and companies' wider statutory duties and obligations.

Our methodology consultation set out five general criteria we proposed to use for assessing whether a cost item should be excluded from the general cost performance modelling:

- cost uncertainty;
- timing uncertainty;
- output uncertainty;
- degree of controllability; and
- materiality.

The majority of respondents commented supported these criteria and we remain of the view that only where costs are material, outside the control of management and uncertain should they be excluded from the general cost performance incentives.

Where we decide to exclude items from cost performance incentives it will be important to ensure that we use a matching treatment in cost assessment and the consideration of affected outcomes – to ensure there are no gaps or double counting between cost assessment and cost performance and delivery incentives.

We will also consider whether there are cost items that it would not be appropriate to allow for in cost assessment or for recovery by totex efficiency sharing factors. For instance if a company were to be fined, it is unlikely to be appropriate to recover a proportion of such costs through totex efficiency sharing factors. It will also be appropriate to consider whether pension deficit costs should be dis-allowed, allowed in part, or allowed in full, in setting cost baselines for standard business plans. We will set out initial proposals on the treatment of pensions when we publish initial baselines in 2014.

As we explained in chapter 4, each company needs to consider how it develops a package of incentives as part of a properly integrated approach.

5.3.1 Menu regulation

We explained in our methodology consultation that there could be advantages in adopting menu regulation alongside totex cost performance incentives, if this could be accommodated within the price review timetable.

Menu regulation can provide extra incentives for companies to reveal information, allows for some extra flexibility in setting totex baselines, provides some additional flexibility in setting efficiency sharing factors and allows companies to better manage risks and rewards. Menus can be constructed such that menu choices are incentive consistent, in that companies gain from both revealing information and achieving greater efficiencies. Customers gain from sharing in these efficiencies.

Respondents generally supported the use of menus, noting that menus would provide useful flexibility for companies to balance risks and rewards.

We have explored two possible approaches to implementing menus.

- Using information in companies' business plans to determine which menu option the company should receive in the light our assessment of its costs (the broad approach used by Ofgem for its Information Quality Incentive, and by us for the CIS at the last price review).

- Allowing companies to choose their own menu option later in the price setting process after we have prepared our own independent cost assessments.

The advantage of the first approach is that it would further encourage companies to reveal information during the business planning process – but in practice it has tended to be used where regulators have asked for two rounds of business planning information. It also does not allow companies any choice – and so contributes less to an efficient approach to risk management.

Using menus later in the review allows a single stage approach to business plans and retains the advantages around baseline flexibility, setting differential efficiency factors and risk management. These facts would suggest using menus towards the end of the price control review process, with companies making choices.

We therefore confirm that we will set menus as part of water and wastewater price controls for enhanced and standard companies, with companies making choices toward the end of the price control review. In order to allow companies the opportunity to comment on the detail of our approach to menus we intend to publish first drafts of menus for standard and enhanced companies alongside initial baselines and draft determinations in 2014 consistent with the approach used by other regulators.

5.4 Cost recovery

A significant proportion of companies' wholesale expenditure comes from investment in long-lived assets. Both current and future customers benefit from that investment, and we therefore seek to ensure a fair balance between current and future customers paying for investment. Since privatisation, we have used RCVs to achieve this – and we confirmed in our methodology consultation that we would continue to use RCVs for wholesale price controls, in line with our future price limits commitments.

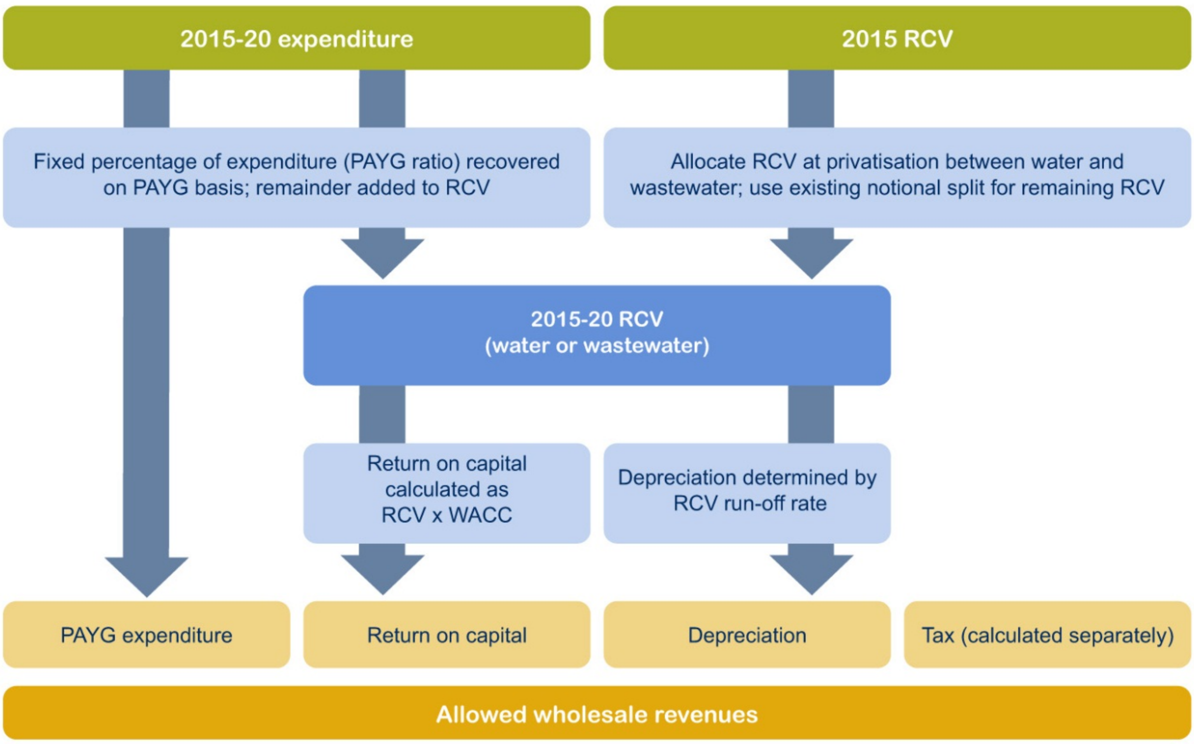
RCVs are a regulatory measure of companies' expenditure on long-lived assets. It is used by investors as a valuation for the regulated business, allowing them to look at the level of borrowings that the companies take on and calculate a gearing percentage. Profitability can be judged by looking at the 'returns' on the RCV.

Customers do not pay for all investment in the year in which it is incurred. Therefore, companies have to borrow against the RCV to fund the shortfall. So to provide the companies with an allowance to fund both interest and repayments of these borrowings we calculate:

- return on RCV – which can be thought of as payments (both interest and dividends) to the providers of finance and;
- depreciation – assets are removed from the RCV over their economic life by way of an annual deduction.

In the methodology consultation, we explained how we proposed to adapt our approach to cost recovery to reflect our move to a totex approach to wholesale expenditure (see figure 6).

Figure 6 Totex approach to cost recovery



As figure 6 shows, allowed wholesale revenues are primarily governed by the level of allowed 2015-20 PAYG expenditure, RCV run-off rates (that is, depreciation charges), the return (the **cost of capital**) on the remaining RCV and an allowance for corporation tax.

We set out our approach to determining the cost of capital for wholesale controls in chapter 9.

In the methodology consultation, we explained that our preferred approach was for companies to propose PAYG ratios and RCV run-off rates in their business plans, which we would then assess (and, where necessary, challenge) as part of the risk-based review.

Respondents who commented broadly supported this approach, with companies welcoming the additional flexibility to manage affordability and financeability. We are therefore confirming our consultation proposals for PAYG ratios and RCV run-off rates.

Ofwat has always set separate (non-binding) price controls on water and wastewater activities – and these price controls have been based on an original split of privatisation asset values between the water and wastewater RCVs, updated for depreciation and subsequent investment in each service area.

Over time new information has emerged on the split of privatisation assets as companies have improved their asset records and databases. In our methodology consultation we suggested that there would be advantages in adjusting the original allocation of privatisation assets to reflect this new information, and, that a pragmatic approach to achieving such rebalancing would be to adopt an RCV split based on the more recent 2009 modern equivalent asset (MEA) revaluations – either at 1 April 2010 or as updated for subsequent additions and depreciation.

A small number of companies raised some concerns about this aspect of our proposals, noting the potential scope for price disturbances if existing notional RCV allocations changed. One company suggested that price disturbances could be mitigated by phasing in changes over a number of price control periods.

We have carried out further work in this area, which suggests that bill impacts could be significant for some groups of customers depending on the specific proposals made by companies. While it is important that price controls are cost reflective, we need to adopt a balanced and proportionate approach to these matters that also considers any adverse consequences of price disturbance.

On balance we have decided not to require a change in approach and so we will not require specific changes to the existing notional split between water and wastewater RCVs at this price review. Instead companies should make their own proposals on these matters, bearing in mind the advantages of more cost reflective approaches and the need to ensure that their proposals are affordable. We will consider these matters (alongside RCV run-off rates and PAYG ratios as part of the risk-based review.

We do not rule out revisiting this issue at future price control reviews to ensure adequate progress is being made toward cost reflective price control arrangements.

5.4.1 Tax

We explained in our methodology consultation that the corporation tax paid by water and sewerage companies depends both on the profits they make, and on the tax relief they claim for:

- interest payments on debt used to finance their activities; and
- investments in certain types of assets (capital allowances).

Water companies are capital-intensive. The tax regime allows them, like any other company to claim tax relief on their expenditure (both the interest cost and capital allowances) to reduce their tax bills – so the tax they pay can appear less than the normal rate of Corporation Tax (currently 24%). But, since we allow for the corporation tax companies pay when we determine price controls, claiming allowances the Government has in place to encourage investment means customers' bills are lower than they otherwise would be. It is important for the companies to maintain legitimacy in the eyes of their customers. In line with our approach to the rest of business plans, we expect company Boards to own and be accountable for the tax elements of their plans.

We also set out our preferred approach to calculating the tax component of companies' allowed wholesale revenues. We proposed adopting a similar method to that used for the 2009 price review (PR09), but with a simplified and less data-intensive approach to the calculation of assumed capital allowances. Under this proposed approach, companies would explain their tax proposals using average capital allowance writing-down rates, rather than providing a detailed breakdown of capital expenditure projections.

The majority of respondents supported our proposed simplified approach to the modelling of capital allowances, although some considered that our proposals would not reduce the burden on companies.

Tax computations are by their very nature, complicated, but we remain of the view that simplifying our approach to modelling capital allowances will reduce some of the regulatory burden of calculating apportionments. It will also result in a simpler and more transparent calculation in the financial model. In view of this, and the largely positive response from stakeholders, we have decided to confirm our consultation proposals.

In assessing companies' proposals for tax, we will continue to use an approach based on projected profits and assumed levels of tax relief.

We will take account of debt interest payments by using the higher of companies' actual proportion of debt financing and the proportion of debt financing assumed in our notional capital structure used to assess companies' proposals for wholesale WACC (see chapter 9).

We will use a simplified approach to capital allowances, based on companies' submitted average capital allowance writing-down rates, by service, for both the brought forward expenditure pool and for new expenditure.

5.5 Assessing wholesale costs– risk-based review tests

In our business planning consultation, we explained that we could use our wholesale cost assessment tools and models to establish ranges ('cost corridors') or thresholds ('cost ceilings') to use as the starting point to assess companies' costs – which would then inform our judgements on companies' proposed wholesale costs in the risk-based review.

We also explained that a company would not necessarily fail the wholesale cost tests if its wholesale costs fell outside the ranges established by our high-level cost tests, but rather that we would then need to consider further the quality of the evidence that the company provided to support its proposals. We noted that clear, well-reasoned and appropriately targeted supporting evidence would be more likely to be effective than a large, unfocused submission.

Respondents broadly supported our high-level approach to the risk-based review tests, but made a number of detailed comments on individual tests. For the proposed wholesale cost assessment some companies wanted to understand more about the proposed use of cost corridors, and some suggested it would be more important that business plans contain convincing explanations of trends in costs rather than falling within the bounds of Ofwat's modelling results and cost corridors.

In response to comments from stakeholders, we have also considered further how these tests will work in practice. Our view remains that an approach to cost corridors or ceilings that use the results of high-level modelling is the best way to create incentives for efficiency while treating all companies with a reasonable degree of consistency.

But we will also conduct a high-level review of business plans to determine whether there is any obvious information we should take account of in finalising the high-level cost models and cost corridors or ceilings. This will be particularly important in relation to wastewater enhancement spending (where the modelling is most difficult), but could also be the case for any other factors that companies convince us are relevant.

Companies should clearly highlight in their business plans explanations of where they think their future costs will be very different from the past.

Bearing the above in mind, we have decided broadly to confirm our proposed approach to the risk-based review test for wholesale costs, subject to drafting changes we have now made to aid clarity, and will use the updated test set out in table 5 for the risk-based review. This will be applied separately to the wholesale water plan element and, where relevant, wholesale wastewater plan element.

Table 5 Proposed risk-based review test for wholesale costs

Test	Key assessment criteria
Wholesale cost assessment	How consistent are the company's proposed costs with our view of an efficient company? To what extent has the company provided sufficiently persuasive evidence in relation to its costs such that we decide that it is appropriate to either modify our approach to the modelling of costs, or, that it is appropriate make specific changes to the cost corridors/thresholds for the company concerned?

6. Securing value for money – household retail controls

6.1 Overview and key decisions

Overview of our approach

In our methodology consultation we confirmed that we would set retail controls that offer customers an appropriate level of protection on service and price, taking account of their ability to choose their supplier– both now and in the future. So, we confirmed that we would use an **average cost to serve** (ACTS) approach to set retail controls for all **household** customers.

In calculating individual company ACTS, in our methodology consultation, we said that our preferred option was to use a measure of unique customers. After carefully considering the responses to our consultation, we have decided to use **a measure of unique customers adjusted for economies of scope** – this is in response to the evidence presented in the consultation responses, and in order to ensure that the controls are fair for all companies regardless of whether they are water and sewerage, or water only, companies.

We have decided that it is most appropriate to use **actual costs, rather than forecast costs**. Using actual costs is a simple and pragmatic approach which most stakeholders supported.

We also confirm that we will **adjust the ACTS to account for levels of metering.** We also confirm the criteria which companies must meet in order to demonstrate that they have unavoidable costs differences, and not just inefficiencies, before we will accept that it is appropriate to make further adjustments to ACTS, including any adjustments for bad debt.

We have decided to use a **three-year glide path** for companies with **actual existing costs above ACTS**, which strikes a balance between delivering savings for customers while not setting unachievable cost reduction targets for high-cost companies.

For companies that have actual **costs below ACTS**, we have decided – to protect customers – that we will set **allowed revenues based on actual costs**. These companies will be able to benefit from future outperformance against their existing costs.

We have decided to **include a net margin in the household retail control** ensuring the price for retail household services covers all relevant costs including a reasonable return, including on future investment made in providing quality services to customers. We will apply a single margin rule to ensure that companies do not gain a return on their existing retail assets twice.

We will not be indexing retail price controls to RPI automatically. If companies consider that uncontrollable input costs exist for household retail activities then they should submit clear and compelling evidence to support their claims. If the evidence is persuasive, we will take the risk posed by these costs into account in setting the level of net margin.

6.2 Setting household retail controls – the ACTS

We have explained in chapter 2 that in the absence of choice, we will need to provide regulatory protection over household retail prices by:

- setting a total revenue control for each company, based on the efficient costs of retail activities (as measured by the average cost to serve, or ACTS) and projected customer numbers; and
- use an annual adjustment mechanism to correct companies' allowed revenues to reflect differences between actual and expected customer numbers and levels of metering.

We expect this approach to deliver a greater overall efficiency benefit for customers than if we were to continue with the current, historic comparative efficiency approach. As with all new regulatory incentives there is a degree of uncertainty and we have therefore proposed that for 2015-20 we will set our efficiency challenge on the 'average' costs of companies as opposed to the costs of the most efficient frontier company. But we see this as part of an evolutionary approach that we hope will enable us to move to an efficient cost to serve over future price controls. We now need to explain in more detail:

- the approach we will take to setting the household retail control;
- how we will set household controls in practice (explained in appendix 2); and
- how the annual adjustment mechanism will work (explained in appendix 2).

We also set out the tests we will use to assess companies' proposed household retail costs as part of the risk-based review.

6.3 Approach to setting the household retail control

In the methodology consultation, we set out a number of key aspects of our preferred approach (see table 6).

Table 6 Consultation proposals for the household retail control

	Consultation proposals
Use of actual or forecast costs in our assessment	No preferred option
Calculating the ACTS	Companies calculate their cost to serve based on the number of unique customers served We calculate the ACTS as an unweighted average of companies' costs to serve
Adjustments to the ACTS	We make adjustments to all companies' cost to serve to reflect differences in levels of metering We consider company-specific adjustments where companies can demonstrate that an issue: • has a material impact on their costs; • is beyond management control (having taken all possible steps to control it); and • impacts the company in a materially different way to other companies

Determining allowed revenues	We would not index household retail controls to RPI, but sought views on alternative approaches to uncontrollable input costs We sought views on whether we should: • use a glide path to phase in the efficiency challenge for companies with actual costs above the ACTS; • allow companies with actual costs below the ACTS to recover the ACTS or their actual costs; and • set a net margin as part of the household retail control

6.3.1 Use of actual or forecast costs

There were mixed views on whether we should use actual or forecast costs. The majority of respondents favoured the use of actual costs, but with adjustments to account for uncontrollable increases in input prices.

Our view is that it is appropriate to use actual costs – this is simpler and more pragmatic than seeking to generate forecast retail costs for all companies and was supported by the majority of respondents to the consultation.

Companies will need to base their business plan submissions on audited data from their 2012-13 regulatory accounts which they should update and assure to be consistent with the decisions set out in this statement.

The ACTS will be calculated using the year 2013-14 data. This is because this will be the latest year of actual costs available at the time we set final determination.

6.3.2 Approach to calculating the ACTS

Almost all water and sewerage companies opposed calculating companies' costs to serve using the number of unique customers. They argued that using this measure unfairly penalises dual service (water and sewerage) companies as it assumes that there are no additional retail costs of providing the same customer with an additional retail service.

We have carried out further analysis which supports this concern – using our proposed 'unique customers' measure results in a definite bias in favour of water only companies. At the same time, we do not think it is appropriate to assume that the cost of providing two retail services is double the cost of providing one retail service, as this ignores potential economies of scope, which most companies agree are significant in retail service provision.

We have therefore carried out further work to estimate the likely economies of scope which arise from providing both water and sewerage retail services to the same customer. This assessment is based on determining the proportion of retail costs that are driven by bill size, rather than by customer numbers. Using accounting separation data for 2009-12, we have derived a provisional estimate of the appropriate economy of scope adjustment: our preliminary view is that a dual-service retail customer should be counted as 1.3 customers of individual retail services when determining company costs to serve.

This estimate accords reasonably well with the limited evidence we received on the issue from respondents to the consultation. We have decided that we will calculate companies' cost to serve using the number of unique customers adjusted for economies of scope, but we will also need to consider data in companies' business plans before reaching a final view on the appropriate adjustment factor for economy of scope.

Respondents agreed with our proposal to calculate the ACTS as an unweighted average of companies' individual costs to serve. An unweighted average of companies' individual costs is appropriate because a weighted average set across total industry costs divided by total number of customers would be more significantly influenced by a small number of very large companies, while an unweighted average would more appropriately reflect each individual company and their management, which is what we want to incentivise. We are therefore confirming this aspect of our proposals.

6.3.3 Adjustments to the ACTS

Respondents overwhelmingly supported making adjustments for levels of metering as metering creates higher retail costs. We do not want to create any disincentives to metering within the price control and we already have clear evidence through tariff differentials that it costs more to serve a metered customer than an unmetered one. We are therefore confirming our consultation proposal to adjust the ACTS to account for levels of metering. For this purpose we will first strip out the costs of metering from the ACTS, and then make company-specific adjustments to allowed revenue to account for expected levels of meter penetration based on information provided through business plans. We will base allowances for metering on the lower of average or company actual additional cost to serve metered customers.

Respondents also supported the broad principles we set out for determining whether to make further adjustments to the ACTS. A number of companies also argued that we should make adjustments to take account of differences in levels of bad debt.

In line with consultation responses, we confirm that companies will be able to seek additional adjustments to the ACTS for any factor which they can demonstrate:

- has a material impact on their costs.
- is beyond management control (having taken all possible steps to control it); and
- impacts the company in a materially different way to other companies.

Assessed against these general criteria, companies have not yet provided compelling evidence to support making automatic adjustments for levels of bad debt across all companies. We therefore confirm our consultation position – we will not make an automatic adjustment for bad debt, but companies will be able to seek an adjustment if they can demonstrate with persuasive evidence that all three of our principles are met.

Any company-specific adjustments we make for issues that meet the three criteria will remove cost differences that are not a result of inefficiency. We will therefore make these adjustments to individual companies' cost to serve before we calculate the average.

Making the case for bad debt adjustments

In response to our methodology and retail consultations, some companies raised particular concerns in the area if bad debt costs and indeed this is an area where 'special factor claims' have been made at previous price reviews. In particular, some companies argued that they would experience materially higher levels of bad debt (even if they were as efficient in collecting revenues from all their customers as an 'average' company) in circumstances where:

- they had larger (wholesale) costs and bills than an 'average' company; and (or)
- they served an area which included higher levels of deprived customers (including for example higher levels of unemployment, income, health, etc) than an 'average' company.

Where companies consider that they are subject to these issues they will need to provide evidence that they have met each of the three criteria for adjusting the ACTS.

The stronger the evidence base presented by companies the easier it will be for us to make these judgements. This will be a high bar and companies will in particular need to demonstrate that the differences in bad debt costs are a result of factors that are outside of their control rather than as a result of inefficient management practices.

To improve understanding and enable consistency and comparability between such claims we would suggest that, at a minimum, companies' wishing to submit such claims should provide:

- levels of average bad debt per household; and
- levels of average bills per household.

Companies should seek to split this information for metered and unmetered customers and provide this data for each Lower Super Output Area (LSOA) in their region. Presentation of this data over a time series would also be welcomed.

If companies cannot provide data at this level of geography they should seek to provide it at some similar low level geography such as Super Output Area (SOA) or Local Authority (LA). Similarly if they cannot provide any of the proposed information or splits of information then they should provide whatever information they can. However, this will obviously affect both the strength of their evidence base and our ability to compare between companies.

Companies' will also need to demonstrate that they are already managing their bad debt costs in ways that are consistent with best practice across both other utilities and within the wider economy – including, where appropriate in considering the role of social tariffs. They should also be clear about the extent to which they believe that they can catch-up to the frontier over the period by becoming more efficient in the collection of bad debt.

6.3.4 Determining allowed revenues

Almost all companies supported using a glide path for companies with actual costs currently above the ACTS.

In taking a decision on whether to use a glide path, we need to consider the overall scale of the efficiency challenge we apply in the round. We want to deliver savings for customers by reducing inefficient behaviour but without setting unachievable cost reduction targets for high-cost companies. In our view, a five-year glide path does not result in sufficiently stretching cost reduction targets for high cost companies. At the same time, not using a glide path would result in some companies being set unachievable targets for 2015-16 given the spread of efficiency in delivering these services at the moment. We have therefore decided that the best approach is to use a three-year glide path, with companies delivering the full (average costs) efficiency challenge by 2018-19. The move to ACTS has been well trailed and effective companies will already be able to start taking action to reduce costs now in order to achieve ACTS by 2018-19.

Some respondents argued that companies with actual costs below the ACTS should in future be allowed to recover revenues based on the ACTS, as this would provide a stronger incentive to reduce costs further. But the majority of respondents felt that companies with costs below the ACTS should be able to recover only their actual costs, so that customers who already benefit from efficiency do not risk losing out in the next price review. Those companies with costs below the average would still be able to benefit from outperformance against their existing costs.

We agree with the majority of respondents. Setting allowed revenues based on actual costs may potentially reduce some incentives for future efficiency gains, but basing allowed revenues on the ACTS would create an expected windfall gain for efficient retailers – without any corresponding improvement in service quality being assured. We have therefore decided that – to protect customers – we should set allowed revenues for efficient companies based on their actual costs.

As the new arrangements become better understood, data improves and high cost companies become more efficient, we hope to continue our evolutionary approach and move towards an efficient cost to serve, based on efficient frontier companies' costs rather than average costs. This would increase the challenge including on above averagely efficient companies.

Most respondents felt that we should use a net margin for the household retail control. Our view is that while setting a net margin for the household retail control would add a little complexity to the process for setting allowed revenues, there are sound economic reasons for including a net margin. A net margin would:

- ensure the price for household retail covered all relevant costs (including a reasonable return); and
- allow the financial performance associated with providing the relevant services to stand alone.

We have therefore concluded that we should include a net margin in the household retail control. We provide more detail on our approach to setting net margins in chapter 9, and to applying them in appendix 2.

Finally, almost all respondents felt that household retail controls should be indexed to take account of uncontrollable changes in input costs – most suggested indexing to RPI for this purpose, although one company felt that the form of adjustment was less important than an adjustment itself. A number of companies provided evidence to try to demonstrate a link between retail service costs and RPI.

We remain of the view that RPI indexation is not appropriate for the household retail control. Indeed, we have not been able to obtain any evidence to suggest that there are material household retail input costs that are beyond companies' reasonable control.

To the extent that companies face uncontrollable input cost pressures on their household retail costs, we will be looking for companies to submit compelling evidence to that effect. We would then take account of those costs when determining the appropriate level of net margin. To date, we have not found the evidence submitted to be compelling.

Appendix 2 sets out in more detail how we will set allowed retail revenues in practice, including how the annual adjustment mechanism will work.

6.4 Household retail costs – risk-based review

We explained in chapter 3 that we will assess companies' business plans using the risk-based review, and that part of our assessment will be targeted tests of companies' household retail costs.

We set out draft tests and assessment criteria for household retail costs in the business planning consultation:

- a test of retail cost allocation, which applied to both retail controls; and
- a household retail cost assessment, which checked the company's proposed cost to serve for consistency with the ACTS and any proposed adjustments to the ACTS in our methodology.

Respondents broadly supported our high-level approach to the risk-based review tests. However, as explained in chapter 3, we want to clarify and simplify our tests for retail costs to increase companies' confidence that a high-quality business plan will access incentive rewards. In particular, we have:

- dropped the test for consistency between the company's proposed cost to serve and the ACTS, as we will be using actual costs to set controls; and
- clarified that our test of cost allocation is a simple check to ensure costs have been allocated in line with regulatory accounting guidelines but with the updates for reported 2012-13 costs discussed in section A1.4 of appendix 5.

We set out our final risk-based review tests in table 7.

Table 7 Proposed risk-based review tests for household retail costs

Test	Key assessment criteria
Retail cost allocation	How clearly and appropriately has the company allocated current and historic costs, including between wholesale and retail, and between household and non-household retail? This test is a simple check to ensure costs have been allocated in line with the latest regulatory accounting guidelines, incorporating updates specified in this statement.

ACTS adjustments	To what extent has the company provided sufficient evidence to show ACTS has been adjusted on the basis set out in this statement and to support any other company proposals for adjusting the industry ACTS, including that any proposed adjustment relates to a factor that: • has a material impact on their costs; • is beyond efficient management control (having taken all possible steps to control it); and • impacts the company in a materially different way to other companies?

7. Securing value for money – non-household retail controls

7.1 Overview and key decisions

In our methodology consultation we confirmed that we would set retail controls that offer customers an appropriate level of protection on service and price, taking account of their ability to choose their supplier– both now and in the future. We confirmed that we would use a default tariff approach to set retail controls for non-household customers and consulted on an efficiency challenge for customers in Wales.

We have explained in chapter 2 that we will regulate non-household retail prices by setting average revenue controls that limit charges for non-household retail services for customers in England and Wales.

In order to set default tariffs for each company, we need to determine:

- the **different customer types** for which we will set default tariffs; and
- the **appropriate average retail revenue per customer** for each customer type.

In this chapter, we confirm our approach will be to **use each company's proposed tariff structures** to determine the different customer types for which default tariffs will be set. This is a simpler and more proportionate approach than setting national customer types or tariffs, and it will minimise any incidence effects on prices for different customer groups.

We have decided that allowing companies to **set default tariffs within a range** of allowed average revenue (or gross retail margin) per customer type for each company strikes the best balance between intervention to protect customers, and allow the market in England to develop and companies to respond flexibly – that is, we will use a 'tariff corridor' approach for 2015-20.

The **non-household control**, as for the household control, will **include a net margin** to secure efficient financing of capital employed in providing non household services, encourage efficient entry and remunerate efficiently incurred risk. If companies consider that there are uncontrollable cost pressures that need to be taken into account then they should submit clear and compelling evidence, and if that is persuasive, we will take these cost pressures into account when setting the net margin for the non-household controls.

Our proposals for default tariffs in England assume that, in line with UK Government policy, non-household customers will have the ability to choose their retailer from 1 April 2017. Because of this, we do not think we need to introduce any additional price protection for these customers, and can reduce the burden of regulation.

We propose to adopt a similar methodology to setting **default tariffs for non-household customers in Wales** in that the customer types will be based on companies proposed tariffs. However, to ensure that we can continue to protect these customers in the absence of choice, we intend to adopt additional safeguards.

We confirm that we will set an up-front non-household **efficiency challenge** for companies operating in Wales based on comparison with equivalent tariffs available to customers in England – these tariffs are likely to provide the best available indication of efficient non-household costs. We will be able to use information that we will collect in any event, for the purposes of setting default tariffs in England, so there will be no additional burden on companies serving customers in England.

These changes are currently focused on companies who operate 'wholly or mainly in Wales'. This reflects the current arrangements that dictate the application of Welsh and English water policy and legislation, which have generally followed company areas of appointment rather than the border between England and Wales. If in the future, if boundaries change to more closely reflect the border rather than the company areas, this may have implications for the price controls of companies who operate in both England and Wales.

7.2 Determining the default tariff structure

In the methodology consultation, we explained that our preferred approach was to use each company's proposed tariff structure – which is likely to be based on their existing tariff structures, but may not be – to determine the different customer types for which default tariffs are set. This is because we felt this was a simpler and more proportionate approach than setting national customer types or tariffs, and it would minimise any incidence effects on prices for different customer groups. It would also support greater company Board ownership of business plans. The majority of respondents who commented agreed with our approach.

We are therefore confirming this approach: we will use each company's proposed tariff structures to determine the number of customer types for which we will set default tariffs.

7.3 Consistency between proposed revenues and costs

We explained in our methodology consultation that there were two possible approaches we could take to determining the appropriate level of operating costs companies should be recovering through their default tariffs:

- using our own (national) assessment of the cost to serve non-household customers; and
- using each company's current non-household retail service costs as the basis for the average revenue controls.

We also invited views on whether we should use historic or forward looking costs.

Respondents did not comment directly on whether we should use our own assessment of costs or companies'. But the companies did express views on whether we should use historic or forecast costs, with no clear preference for one approach over the other.

We have carried out further work in this area, considering and assessing the options we set out in the methodology consultation, as well as a further option: using companies' current costs, but subject to additional checks.

Our view is that the approaches based on companies' own current costs are significantly more proportionate than making our own assessment of appropriate costs – which would be more complex, and could significantly increase regulatory burden.

The principal difference between the two approaches is whether we carry out additional checks on company's proposed costs (see section 7.6 and chapter 9 for more details on these checks). Our view is that, provided we take a proportionate and targeted approach to these checks, the benefits of some additional checks (in terms of increased effectiveness) are likely to outweigh the costs.

7.3.1 Dealing with uncontrollable input price risk

In the methodology consultation, we explained why we do not consider RPI indexation would be an appropriate mechanism for reflecting uncertain and uncontrollable input price risks in retail controls (including the non-household control. We set out (and sought views on) three possible options:

- making no explicit allowance for input price inflation, based on an assumption that companies can control and manage all the relevant risks;
- ensuring that the non-household retail control over the period 2015-20 has sufficient net margin to cover the risks of unexpected uncontrollable changes in input prices; and
- using a pre-set measure that reflects the future changes in relevant efficient costs of a retailer providing non-household services.

Most respondents noted that – unless it is taken into account in price controls – cost inflation will reduce the margins available to all retailers (including potential or recent entrants) and may ultimately result in a margin squeeze that drives out entrants. One respondent commented that RPI indexation was not the best approach, and suggested that the majority of retail costs were likely to be within companies' control.

We remain of the view that RPI indexation is not appropriate for the non-household retail control, which is consistent with our approach to the household retail control. Indeed, we have not been able to obtain any evidence to suggest that there are material non-household retail input cost pressures that are beyond companies' reasonable control.

To the extent that companies face uncontrollable input cost pressures on their non-household retail costs, we will be looking for companies to submit compelling evidence to that effect. We would then take account of those cost risks when determining the appropriate level of net margin.

7.4 Delivering retail market opening by April 2017 through the Open Water programme

The Open Water programme was jointly established by Ofwat and the UK Government to take forward some of the work associated with a retail market opening date of April 2017 and upstream market opening no sooner than 2019 in England. It has recently published 'Open Water - The new retail market for water and sewerage services – a discussion paper', which sets out some of the key issues that will need to be considered in developing the retail market.

Hitting the retail market opening date is important because if there is delay then non-household customers in England will not be eligible to choose their supplier until sometime towards the end of the next price review period and, depending on the duration of that delay, this would most likely require some form of price and service regulation for part of that period and a change to the current methodology described here. In particular, default tariffs would most likely need to change to accommodate price and service incentives similar to those that we will continue to apply to customers in Wales.

In order to open effective retail and upstream markets it will be necessary to introduce some new obligations onto English companies. Market rules will need to be established through codes describing how companies must engage with market participants and these rules are likely to contain requirements on companies in terms of, for example, the format and structure of their customer data to ensure consistency across a national market and enable efficient and easy customer switching. We will discuss some of these issues in more detail in our forthcoming discussion documents on governance and level playing field. Similarly, it is likely that some proportionate controls will need to be introduced to address issues of discrimination.

If companies consider that they will incur material costs in this area then, in line with other legislative changes that affect companies, they should submit clear and compelling evidence to support this explaining what costs will be incurred undertaking which activity. If the evidence is persuasive, we will take these costs into account in setting the level of default tariffs and associated margins. Similarly, any material wholesale costs arising from these changes should similarly be evidenced in business plans for controls for these services.

7.5 Setting an efficiency challenge for Welsh companies

We explained in chapter 2 that we will set a non-household retail efficiency challenge for Welsh companies.

In the methodology consultation, we sought views on two possible approaches we could take to setting that efficiency challenge:

- applying the efficiency challenge faced by household retailers under the ACTS; and
- an alternative efficiency challenge, based on comparisons with actual non-household tariffs in England.

Some respondents to the consultation supported using comparative data from England; others questioned whether this was a proportionate approach, given the additional regulatory burden this would place on English companies.

We also held a stakeholder workshop which covered a range of issues related to non-household controls for Wales. Attendees at the workshop supported an approach where we:

- set an up-front efficiency challenge as part of PR14 (possibly based on the household ACTS efficiency challenge); and
- apply a further backward-looking adjustment at the next price review, based on comparisons with prevailing English tariffs.

We agree with stakeholders that an up-front efficiency challenge is important to protect non-household customers of Welsh companies in the short term. However, we think the best approach to the up-front efficiency challenge is to make use of comparisons with non-household default tariffs of English companies, rather than comparisons with household costs. This is because English non-household tariffs are likely to provide a better indication of efficient non-household costs.

We also agree with stakeholders that a backward-looking adjustment at the next price review is the most effective and proportionate way to capture the dynamic benefits that competition delivers for non-household customers in England.

We therefore confirm that we will:

- set an up-front non-household efficiency challenge for Welsh companies, based on comparisons with equivalent English default tariffs; and
- make a further backward-looking adjustment when we next set price controls for the affected companies, based on comparisons with competitive tariff offerings for non-household customers of English companies.

7.6 Non-household retail costs – risk-based review

Consistent with our approach of encouraging greater company Board ownership of business plans – and reflecting the 'back-stop' nature of default tariffs in England– we explained in our business planning consultation that we want companies to put forward proposed default tariffs. We also explained that we would then assess proposed tariffs for customers in both England and Wales using risk-based review tests.

We explained in chapter 3 that we will assess companies' business plans using the risk-based review, and that part of our assessment will be targeted tests of companies' non-household retail costs and tariffs.

We set out draft tests and assessment criteria for non-household retail costs in the business planning consultation:

- a test of retail cost allocation, which applied to both retail controls; and
- tests of companies' proposed non-household default tariffs – looking at the expected revenues recovered by tariffs and testing for undue discrimination between customers (or customer classes).

Respondents broadly supported our high-level approach to the risk-based review tests. A number of companies sought more detail on how we would implement these tests in practice, and were particularly concerned that our approach to retail costs might make it too difficult to 'pass' the risk-based review.

As explained in chapter 3, we want to clarify and simplify our tests for retail costs to increase companies' confidence that a high-quality business plan will access incentive rewards. In particular:

- we have clarified that our test of non-household retail cost allocation is a simple check to ensure costs have been allocated in line with regulatory accounting guidelines but with the updates for reported 2012-13 costs discussed in section A1.4 of appendix 5; and
- we have placed the onus on companies to provide assurance that their default tariffs do not unduly discriminate between customers.

We set out our final risk-based review tests in table 8.

Table 8 Proposed risk-based review tests for non-household retail costs

Test	Key assessment criteria
Retail cost allocation	How clearly and appropriately has the company allocated current and historic costs, including between wholesale and retail, and between household and non-household retail? This test is a simple check to ensure costs have been allocated in line with the latest regulatory accounting guidelines, incorporating updates specified in this statement.
Default tariffs	How well do the company's proposed default tariffs ensure it recovers no more than appropriate proportion of its allowed costs and net margin? How adequate is the company's assurance that its proposed default tariffs do not unduly discriminate between customers in a given customer class or between customer classes? We will have a particular focus on the evidence that smaller non-household customers are not subject to undue discriminatory tariffs.

We explain our approach to assessing proposed net margins in more detail in chapter 9.

8. Using resources better

8.1 Overview and key decisions

Overview of our approach

There is scope for significant benefits to consumers, including current and future customers and the environment, if companies make better use of water resources, including:

- reduced financial costs;
- increased resilience of customers' water supplies; and
- reduced pressure on the environment caused by abstraction – particularly in areas where water is scarce.

Over the long term, we expect our new totex approach to wholesale costs to encourage better, and more efficient, decisions on the use of water resources – including decisions on whether to develop new resources or purchase water from another water company or a third party. The UK Government's proposed long-term reforms to the abstraction licensing regime will also have a key role to play.

But we also want to improve the way companies use resources in the short term. So, we are confirming the introduction of two incentives to drive changes in company behaviour:

- **water trading incentives** – designed to encourage companies to trade water where it is beneficial to do so; and
- the **abstraction incentive mechanism (AIM)** – designed to reward or penalise companies depending on their levels of abstraction at low flows from environmentally sensitive sites.

In the water trading incentive, we confirm that we will introduce **incentives for both new water exports and new water imports**. For all new qualifying exports that start during 2015-20, we will allow exporters to retain 50% of the lifetime economic profits (that is, the profits over and above the normal return on capital invested).

Importers will benefits from totex efficiency sharing incentives. We will also allow **importers to retain 5% of their costs** from new qualifying imports during 2015-20. Companies will benefit more from this incentive if they bring forward new imports earlier in 2015-20.

As well as setting incentive rates, we have considered carefully how best to protect customers and secure efficient trades. We consider that we can achieve our objectives effectively through the use of a **cap on total annual import incentive rewards of 0.1% of water activity turnover in any year of the control period** and through **trading and procurement codes** which will require companies to be transparent about water trading, allowing checks on whether trades are efficient to be carried out.

Our water trading incentives will apply only to relevant price regulated companies. In relation to transactions with new appointees, we will address whether and how we apply water trading incentives when we consult separately on the detailed form of a service incentive for new appointees.

We will **implement the AIM during 2015-20 on a reputational basis**. Experience shows that companies place significant value on achieving high ranking in league tables that we set, even going so far as to link management incentives directly to them. The reputational incentive will therefore act as a powerful tool for changing abstraction patterns at the same time as allowing companies and the Environment Agency to improve the data and learn how the incentives might work when financial penalties and rewards are added.

8.2 Water trading incentives

In the methodology consultation, we explained that our preferred approach to encouraging beneficial water trading was to:

- introduce targeted incentives for both exporters (sellers) and importers (buyers) of water;
- encourage exports by increasing the proportion of profits from trades retained by companies; and

- encourage imports using a cost over-recovery approach based on a fixed percentage of import costs.

We also explained that we were exploring ways we might protect customers and ensure we did not encourage inefficient trading – including offsetting certain import incentives against export incentives, setting a cap on the total incentive rewards available to importers and the use of Trading and Procurement Codes.

Most respondents supported the proposed use of water trading incentives – but were concerned about the complexity of our proposals. There were mixed views on Trading and Procurement Codes with a number of stakeholders expressing concern about the potential administrative burdens.

In the light of consultation responses, we confirm the broad approach to incentives for both new water exports and new water imports, but we will simplify some of the detail of our proposals, and will not introduce any administratively burdensome processes.

We also recognise there are other barriers to water trading that also need to addressed. Stakeholders have, for example, cited barriers arising from the implementation of the abstraction licensing regime. But we did not consider it right to use the existence of other barriers as a reason not to take forward our incentives.

To qualify for water trading incentives, companies must comply with Trading and Procurement Codes. However, these will only contain simple obligations in respect of definitions of trades, non-discriminatory procurement, and, economic and environmentally rational trading – necessary in particular to help ensure the incumbent water companies do not abuse their market power.

Conditions that must be included in the Trading and Procurement Codes and our advice on additional principles are set out in appendix 3.

The main aspects of proposals for incentives are consistent with the methodology consultation.

- For all new qualifying exports that start during 2015-20, we will allow exporters to retain 50% of the lifetime economic profits (that is, the profits over and above the normal return on capital invested).

- Importers will benefit from totex efficiency sharing incentives and an extra 5% of the costs of water imported under new agreements – subject to the annual total of these extra payments not exceeding a cap of 0.1% of the importer's water activity turnover in any year of the control period.

- We consider that setting a cap at this level ensures that customers do not pay more under the incentive than is needed to encourage efficient trading.

- The extra import incentive is designed to try and kick start water trading and so we will commit to making these payments only during the period 2015-20. The main purpose of an import incentive is to act as a stimulus to change cultural and behavioural biases and, therefore, once those biases have been addressed there may no longer be a strong case for an extra import incentive on top of the benefits reducing totex.

Our water trading incentives will apply only to relevant price regulated companies. In relation to transactions with new appointees, we will address whether and how we apply water trading incentives when we consult separately on the detailed form of a service incentive for new appointees. Any other entities that are able to enter the market and trade water will be able to retain 100% of the profits as they will not be regulated and so no further incentives for these entrants are needed.

8.3 The abstraction incentive mechanism (AIM)

In the methodology consultation, we explained that the purpose of the AIM was to target those over-abstractions with the highest risk of causing environmental damage, and, that this would be an important transitional incentive while the Government developed wider proposals for abstraction reform.

We also explained that we had considered a variety of different approaches to the AIM. Our preferred approach in the consultation was to use financial incentives that would:

- apply to water company abstractions affecting Water Framework Directive Band 3 water bodies – those where the Environment Agency has greatest confidence in the risk of environmental damage;
- apply to abstraction below a flow threshold – a fixed percentage of the Environmental Flow Indicator (EFI) relevant to the site;
- use a baseline, perhaps based on historical average over abstraction, as a basis for judging future performance on over abstraction; and

- use a uniform national financial incentive rate, informed by the data on WTP from the National Water Environment Benefit Survey to incentivise reductions in over-abstraction.

Most respondents supported the AIM in principle, but raised a number of concerns around its scope and implementation.

- A number of stakeholders (including environmental groups) suggested that the scope of AIM should be widened to include abstractions affecting Water Framework Directive sites in Bands 1 and 2 (which are assessed as being potentially at risk, but with lower confidence than Band 3) – to prevent any environmental deterioration caused by companies switching from abstractions impacting Band 3 sites to abstractions impacting Band 1 and 2 sites.

- Companies raised practical implementation concerns, and suggested more than one shadow year might be needed before the AIM could be fully implemented.

We recognise the importance of these points and have taken them into account in our revised proposal for the AIM.

We, and UKWIR, carried out further work and testing on the AIM during the consultation period. This work has revealed significant concerns over the quality of available data – including data on the number of abstractions relating to Band 3 sites in each licensee's area. For example, to illustrate the magnitude of the data concerns, from one dataset we initially understood that three particular companies had 57, 70, and 113 abstractions impacting Band 3 sites – but a different dataset subsequently suggested they had 0, 0, and 1 Band 3 abstractions respectively.

We have worked hard alongside colleagues in the Environment Agency, and with companies, but it has not been possible for us to secure the robust data we would need to set financial incentives nationally in 2015-20.

While we have concluded that we cannot implement financial incentives for 2015-20, we intend to take forward the AIM as one of a number of initiatives designed to ensure that water companies take account of the important goal of sustainable abstraction in operating their businesses during 2015-20. And of course, companies can include costs associated with statutory obligations on companies, or where customers are willing to pay for non-statutory schemes, in business plans to address abstraction concerns (including in relation to schemes to tackle RSA sites). We will make allowances for reasonably efficient costs in setting price controls.

We will **implement the AIM as a powerful reputational incentive** from the beginning of the price control period and over 2015-20. Our working assumption is that we will focus AIM on Band 3 sites which should be those most vulnerable to environmental damage, but also include monitoring of (if it is practical) the position at 1 and 2 sites to limit the scope for damaging substitutions in abstraction, consistent with the views of stakeholders. By putting companies' reputation at stake under this incentive, we expect to make rapid progress on data quality, both to ensure that data is of sufficiently good quality to support such a reputational incentive by April 2015, and to be able to implement financial incentives from 2020.

We also expect reputational incentives to be an effective and powerful tool for changing abstraction patterns. Experience shows that companies place significant value on achieving high ranking in league tables that we set, even going so far as to link management incentives directly to them.

Our intention is to publish the AIM data and a comparison of companies regularly so that stakeholders can assess companies' performance and apply pressure to poor performers. Companies will need to ensure their data is of good quality for the comparisons to be accurate. We will set out the details of the AIM reputational incentive when work on data issues has progressed sufficiently.

In addition to AIM, we strongly encourage companies to include within their outcome packages outcome commitments and, as appropriate associated financial incentives, relating to over-abstraction from environmentally sensitive water bodies. This would require relevant local data that this is reasonably robust and it will be for companies to work with stakeholders (including local Environment Agency offices and CCGs) to provide reasonable assurance on local data. Consistent with the general approach to outcomes (see chapter 4) we would expect any outcome commitments and ODIs to reflect customer preferences and WTP.

If a company has set itself a well-designed, evidenced and stretching abstraction outcome commitment and delivery incentive, this is likely to benefit the company within the reputational comparisons of companies under the AIM.

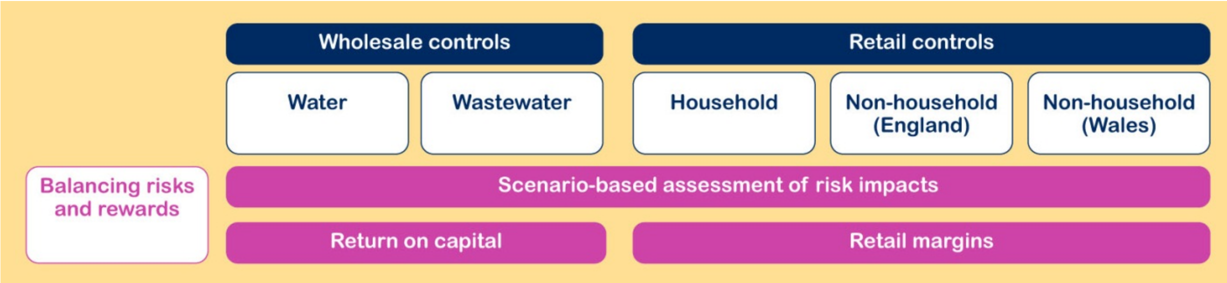
One of the key drivers for the AIM was to help avoid or reduce any perverse impact that water trading incentives might have on over-abstraction. In general we would expect the water trading incentives to encourage the transfer of water from areas with plenty of water to areas of water scarcity thus benefitting the environment. But the AIM reputational incentive will help disincentivise any environmentally perverse trades that might be considered by companies.

In addition we are proposing that each company's Trading and Procurement Code explain and illustrate the processes that the company has for ensuring that any trades involve environmentally rational flows. A company will not receive water trading incentives unless it is able to report satisfactorily against a Code that we have approved.

9. Balancing risks and rewards

9.1 Overview and key decisions

Overview of our approach



All businesses face risks – and prudent companies will take steps to understand, manage, and mitigate, significant risks to their operations and profitability. Water and sewerage companies are no different – they face a range of risks which might affect their ability to deliver for consumers, to their financial position, and to the returns available to their investors. And they too must take steps to understand, manage and mitigate the most significant risks.

We explained in our methodology consultation that we wanted to take a more systematic and quantitative approach to analysing how companies are managing their risks (and its allocation between companies' investors and customers) for PR14.

We confirm our consultation proposal to use an approach based on **scenario modelling to analyse risk** and explore the overall balance of risks to RORE. We have responded to feedback from respondents, and simplified our approach, reducing the number of modelled scenarios required from companies. As explained in chapter 1, we are publishing PwC's report 'Economic assumptions for PR14 risk analysis' alongside this document.

In the methodology consultation, we confirmed that we would continue to allow companies to earn a regulated return on their RCV as part of wholesale controls, and that we would do this using a **WACC** approach.

We have done further work on the detail of WACC and (as explained in Chapter 1) we are publishing PwC's report 'Cost of capital for PR14: methodological considerations' alongside this document. We confirm that we will continue to use a **notional capital structure for setting WACC** taking account of the change in gearing levels since we last set price limits. These changes together with developments in other utility sectors suggest our notional gearing assumption should be in the range of 60% to 70%.

It remains the case, however, that highly-geared, securitised structures are untested against the full range of potential risks, and new risks may emerge that challenge these structures. So we now announce our intention to introduce a **financial structure monitoring regime**, to keep under review and assess the risks to customers posed by companies' financial structures.

We confirm that we will retain our existing approach to the cost of debt based on forward-looking expectations, and will use **a fixed cost of debt from 2015-20** – we consider that it would be inappropriate for us to change from our existing approach when prevailing debt costs are very low.

We also confirm that we will continue to use our existing approach to the cost of equity, based on the **capital asset pricing model (CAPM)**, alongside cross checks to other approaches and informed by our scenarios work.

In our methodology consultation, we noted that when deciding on retail margins, we need to think about the **payment terms between retailers and wholesalers**. This is important because the approach to payment terms affects the cash flow and hence the costs of working capital of wholesale and (non-household) retail.

The issue of payment terms was discussed by the Open Water programme and we listened carefully to the views. We now confirm key principles including retailers paying wholesalers in arrears, and a consistent billing period and a consistent settlement period across the non-household market. More details on billing, settlement and credit requirements should be proposed by Open Water by the end of October.

9.2 Risk – a scenarios-based approach

Prudent and efficient companies should be taking steps to understand the key risks to their operations and profitability, and putting in place appropriate measures to manage and mitigate those risks. We expect companies' Boards to explain clearly in their business plans how they have identified, mitigated and managed risks.

We also explained that our preferred approach to analysing how well business plans manage risks was to use **scenario modelling**, which we could use to explore potential financial and other impacts of companies' proposed incentive packages – and in particular, in relation to financeability, the overall balance of risks to RORE. This focus on risks to equity in understanding an efficient allocation of risk between the different providers of companies' finance was based on the assumption that equity investors will bear and manage most of the risks and rewards from regulatory incentives. We set out our proposed approach in more detail – including our proposed scenarios – in the business planning consultation.

This analysis is a central part of understanding whether companies' proposals demonstrate efficient levels and allocations of risk. As part of this, one important factor we will need to consider is the extent to which companies are managing and mitigating their risks – and whether they are making effective use of the tools available to do so.

Respondents broadly agreed with our proposed approach to assessing the balance of incentives and risk – and particularly welcomed our proposed more quantitative approach to assessing risks. We therefore confirm our proposed approach of using scenario modelling to assess risks.

Respondents also made detailed comments on our approach – and on our proposed scenarios in particular. We discuss these concerns in the following section.

9.2.1 Scenarios for assessing risk

In the business planning consultation, we set out the scenarios we proposed to use. We explained that our preferred approach was to examine upside and downside cases for nine types of scenario (see table 9), based on our view of key risk drivers. We also proposed that we should specify some appropriate base case assumptions for the economic scenarios.

Table 9 Proposed scenarios for risk assessment

Common external risks	Company-specific risks
A. Household growth B. Industrial demand C. Cost input inflation D. Overall economic impact (including the individual risks in scenarios A–C) E. Rainfall	F. Company-specified scenario 1 **(optional)** G. Company-specified scenario 2 **(optional)** H. Company over- and under-performance in relation to its specific regulatory commitments (targets and incentives) in its business plan I. An overall combined scenario capturing all material risks, relevant for finance providers and customers

Respondents made a number of comments on our proposed scenarios. Some companies noted that we were proposing to collect large volumes of data for our proposed scenarios (particularly the rainfall scenario), and that this could result in significant regulatory burden. Some also suggested possible simplifications. A number of companies also felt that scenarios should focus more on company-specified (rather than Ofwat-specified) risks as this would be more consistent with company Board ownership of business plans.

In the light of consultation feedback, we have looked again at our proposed package of scenarios. We are satisfied the overall package remains appropriate but accept the views of respondents that it is appropriate for more to be specified by companies based on their specific risk exposures. We have also reduced the number of modelled scenarios required from companies.

Our view is that scenario D (overall economic impact) provides us with important information about different companies' susceptibility to overall economic shocks, and should remain mandatory for all companies so we can understand the relative exposure of different companies to common national macroeconomic uncertainties.

Within these overall economic risks, scenarios A-C are designed to provide more granular information relating to the particular impacts of specific economic shocks. Depending on company circumstances and mitigations, some of these may not be particularly relevant to individual companies. We have therefore decided to make these scenarios optional for companies, as this more granular information may not be necessary for all companies.

However, we would expect companies to include information on these scenarios if changes to demand or costs represent material risks within the overall economic risk exposure indicated in scenario D, and in particular if the company is proposing particular regulatory mitigations for these risks in its proposed incentive package.

Clearly, weather is the key non-economic risk affecting all water and sewerage companies in England and Wales – and the most important weather variable relevant to financial risk analysis is rainfall. We remain of the view that scenario E is an important part of our analysis, and that prudent companies should understand the impact of increases or decreases in rainfall on their plans – depending on company circumstances, these impacts may be of varying materiality, but it is important for us to understand the relative financial exposures in the sector. Scenario E will therefore remain mandatory for all companies.

Scenarios H and I provide important information about performance risks and companies' overall view of risks – both those specific to the company and those arising from external circumstances and the sector regulatory framework – that are particularly relevant for calibrating incentives and assessing affordability and financeability. Scenarios H and I are a key input to our risk-based review, and we remain of the view that they should be mandatory for all companies.

We have therefore decided to use the scenarios set out in table 10 for our risk analysis.

Table 10 Final scenarios for risk analysis

Common external risks	Company-specific risks
A. Household growth (**optional**) B. Industrial demand (**optional**) C. Cost input inflation (**optional**) D. Overall economic impact (including the individual risks in scenarios A–C) E. Rainfall	F. Company-specified scenario 1 (**optional**) G. Company-specified scenario 2 (**optional**) H. Company over- and under-performance in relation to its specific regulatory commitments (targets and incentives) in its business plan I. An overall combined scenario capturing all material risks, relevant for finance providers and customers

As indicated above we recommend companies supply us with the results from up to two additional company-specific scenarios; however if there are additional significant company-specific risks which have material impacts on companies and (or) customers, then additional scenarios may also be provided.

It is important that companies model these scenarios as consistently as possible – particularly for common external risks – as this will help ensure we can apply our risk-based review tests consistently and fairly. To help ensure consistent use of external input assumptions for the affected scenarios, we are publishing PwC's report 'Economic assumptions for PR14 risk analysis' alongside this document. This sets out which independent national forecasts companies could use as reference points when establishing base cases – and the approach companies should take to specifying 'upside' and 'downside' variants of those base cases.

As set out in the business planning consultation, we think these independent national forecasts are reasonable for the purpose of guiding business planning by individual companies, but we will not require companies to use these forecasts in developing their own plans. Rather, companies should inform us when their assumptions differ materially and provide supporting evidence for the difference (for example, regionally different economic prospects to those in the independent national average macroeconomic forecasts).

9.3 Remunerating risk – a tailored approach

We explained in our methodology consultation that our scenario modelling would inform our considerations about how risk should be remunerated – both for wholesale and retail controls. We proposed to take different approaches to remunerating risk and capital employed for wholesale and retail controls.

For wholesale controls, we said we would use the establish approach of a regulated return on companies' RCV, and that we would continue to do this using a **WACC** approach.

But because retail activities and services are unlikely to require significant capital investment (and we are allocating the whole of the 2015 RCV, including existing retail assets, to wholesale), a return on capital approach for setting allowed returns would be inappropriate for retail controls. Instead, we said we would remunerate retail risks and the cost of capital employed (if required given the basis for allowed costs) using **retail net margins**. We have now confirmed (in chapters 6 and 7) that we will use net margins for both retail controls in conjunction with actual costs as the basis for allowed costs.

We developed the detail of our approach further in the business planning consultation, where we explained that we expect companies' business plan proposals to set out clearly how they have analysed, mitigated and managed risks.

We also explained that our preferred approach was for companies to propose wholesale WACC(s) and retail net margins in their business plans, which we would then consider as part of the risk-based review.

Respondents agreed with our high-level approach to assessing the balance of incentives and risk. They also supported the continuing use of a WACC approach for wholesale controls, on the understanding that we would continue with our historic approach to the WACC, and the use of net margins for retail controls – though they asked for more detail on our approach to net margins. We confirm our overall approach.

- Companies' Boards will need to take account of risk in developing their business plans, and put forward appropriate proposals to manage and mitigate risk.

- We will tailor our approach to remunerating risk to reflect the different characteristics of wholesale and retail controls, using:
  - the established approach of a regulated return on companies' RCVs (using a WACC approach) for wholesale controls; and
  - a net margin approach for retail controls.

- Companies will also need to put forward appropriate proposals for wholesale WACC(s) and net margins which provide rewards that are appropriate to the risks they are bearing.

We now provide more detail on the approach we will take to assessing companies' proposals for wholesale WACC and retail net margins.

9.4 Assessing WACC proposals

To assess whether a company's WACC proposals provide rewards that are appropriate to the risks companies are bearing, we will need to reach a view on the appropriate level of the WACC – taking account of our risk analysis.

In our methodology consultation we confirmed that we would continue to derive our view of the WACC in real terms and use it for the whole control period, as the RCV and allowed revenues will be indexed by RPI. We also set out our proposed approach to estimating the three key parameters needed to calculate an appropriate WACC:

- gearing (the respective proportions of finance provided by debt and equity);
- the cost of debt finance; and
- the cost of equity finance.

Supported by our consultants PwC, we have carried out further work developing the detail of our approach to the WACC – in particular, examining:

- how to address potential concerns about capital structures in the sector on a forward-looking basis;
- the use of a single notional capital structure, and the appropriate range of notional gearing to assume; and
- our approach to setting the cost of debt and equity.

9.4.1 Potential concerns about capital structures

As highlighted in 'Observations on the regulation of the water sector', there are concerns that:

- setting a single notional WACC encourages companies to increase levels of gearing – particularly in an environment of cheap debt financing; and
- highly geared companies may then be unsustainable.

These concerns were also echoed by a small number of respondents, who raised concerns about highly-geared structures, and how any financial benefits arising from these structures should be shared with customers.

Supported by PwC, we have carried out further work in this area (see PwC's report, 'Cost of capital for PR14: Methodological considerations' published alongside this document). In view of this report, and responses to the consultation, we conclude that neither further regulatory intervention on limiting companies' gearing nor changing our basic approach to setting the cost of capital based on industry notional capital structures is required at this time. However, new risks may emerge and it is important that we continue to monitor them so that the regulatory framework remains robust on a forward-looking basis.

We have therefore decided to introduce a **financial structure monitoring regime**. This will allow us to continue to assess industry financial resilience and the risks to customers posed by companies' financial structures (including new approaches that may emerge over time) – and to identify whether (and when) it might be appropriate for us to intervene to protect customers.

The monitoring regime will provide a published regular annual review of:

- financial performance of all water companies;
- key risks faced by sector;
- stress testing of water company financial performance;
- sector analyst and rating agency assessment; and
- ad hoc special interest topics which relate to the risk environment or water company financing structures.

Further description is provided in the PwC report 'Cost of capital for PR14: Methodological considerations'. We will consult further on the design and implementation of the financial structure monitoring regime over the next year.

9.4.2 Gearing

We explained in our methodology consultation that our preferred approach was to continue using a notional industry-level assumption for gearing. We also explained that clear market evidence would be needed to justify different treatments for different companies.

Our further work, and PwC's advice, indicates that:

- a notional gearing approach remains fit for purpose as an economic regulator has no better information on which to base detailed financing decisions, and companies are best placed to manage risk relating to structure, types and timing of financing;
- there is not persuasive evidence (or theoretical rationale) available at this stage to indicate significantly different exposure to risks between companies;
- based on current sector gearing levels, consistency with meeting regulatory financeability targets, and regulatory benchmarking from other sectors all suggest a notional gearing assumption in the range of 60% to 70%, somewhat higher than we have assumed before.

In view of this, and responses to the consultation, we confirm that we will continue to use a notional capital structure approach to the WACC when we set wholesale controls for 2015-20.

We will finalise our WACC assumptions, including for assumed levels of gearing, in 2014 – once we have considered the evidence provided by companies in their business plans (which should have been tested through customer engagement).

We will also retain the policy adopted at PR09 which ensures we claw back, at a future price review, the tax benefits arising from any capital restructuring in 2015-20. We will claw back such tax benefits where there is a one-off step change in gearing that is the result of a financial restructuring – and where interest costs in any subsequent year exceed those assumed in setting price controls. This will ensure that tax benefits arising from any financial restructuring are passed back to customers.

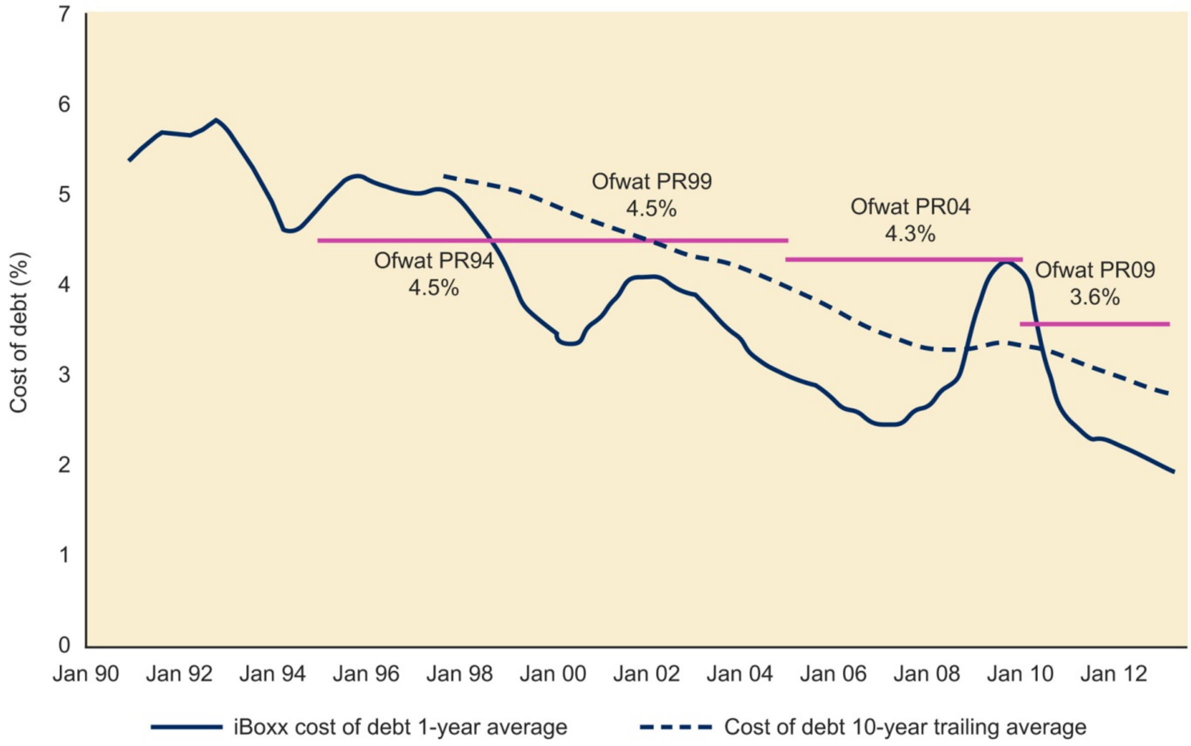
9.4.3 Cost of debt

In the methodology consultation, we explained that our preferred option was to continue using the approach taken to assess the cost of debt in previous price reviews, combining direct observations from companies' existing debt portfolios and forward-looking projections.

Our further work in this area has examined whether – in the light of companies' consistent outperformance of regulatory assumptions on the cost of debt in recent years – alternative approaches to the cost of debt might be warranted.

Because, historically, we have set a 'fixed' cost of debt for each price control period, our assumed cost of debt has 'lagged' changes in actual market rates. The sustained and consistent downward trend in the market cost of debt over the last 20 years has therefore created opportunities for companies to outperform (see figure 7).

Figure 7 Assumed and actual costs of debt 1990-2012



But a 'fixed' cost of debt approach has significant advantages. It creates strong incentives on companies to reduce their actual debt costs. And while customers do not immediately share in the benefits when debt costs fall, they are also protected when debt costs rise. Over the longer term, we can ensure customers benefit from lower sustained debt costs, by lowering the assumed cost of debt in given price reviews as the prospects for debt costs fall.

PwC reviewed alternative approaches to setting the cost of debt for use in the WACC, such as debt indexation and pain/gain sharing, and consider that these approaches weaken the incentives on companies to continue to seek low finance costs – as a proportion of any cost increases could be recovered from customers.

These approaches also give customers less protection from increases in debt costs. In the long term, these approaches could mean that customers, who are less well placed to manage finance risks than companies, are worse off – particularly if we were to change from our existing approach when prevailing debt costs are very low. PwC also advise that pain/gain sharing approaches would raise complex reporting and analytical challenges in assessing pain and gain, and may raise risks of gaming.

In the light of this further work, we have concluded that we should retain our existing approach to the cost of debt – and will use a 'fixed' cost of debt approach for 2015-20.

For this purpose, we note that market evidence is consistent with lower debt costs over the medium term, and that, in practice, companies have been able to access debt at rates below our regulatory assumptions. Both of these facts suggest that a lower assumed cost of debt is likely to be warranted for 2015-20.

However, in line with our approach to notional gearing, we will continue to review relevant market evidence, including company financing proposals in business plans (which should have been tested through customer engagement), before finalising our assumptions for 2015-20.

9.4.4 Cost of equity

We explained in the methodology that we would continue to use our existing approach of drawing on a range of evidence to help estimate the cost of equity for the WACC including focusing on approaches based on the capital asset pricing model (CAPM), and using cross-checks to other approaches such as the dividend growth model. Our assessment would also be informed by our analysis of the impact of our proposed incentive package on RORE using scenarios, as discussed above.

We have carried out further work on the detail of our approach to the cost of equity. In line with our approach at previous price reviews, we will continue to base our estimates of these components on available market data and evidence. An initial analysis of current market data undertaken by PWC indicates that the cost of equity has fallen since PR09. PwC also find that companies' returns on equity during AMP5 exceeded the allowed cost of equity, due to the low cost of debt during the period discussed above.

Transaction prices (both from successful and unsuccessful bids) for water company acquisitions provide some evidence on the appropriate allowed equity return for the WACC. In this context we note the continuing trend for acquisitions at prices above the prevailing RCV – although we acknowledge that these premiums could be due to a range of factors including those not relevant to the WACC for the regulated business.

Overall, market evidence appears to be consistent with a lower cost of equity than we assumed at PR09, in line with the evidence on the cost of debt. However, we will update our analysis our determinations in 2014. For this purpose, as noted above, we will finalise our WACC assumptions – including for the cost of equity and debt as well as gearing – in 2014 once we have considered the evidence in companies' business plans.

For this purpose, we will need to ensure our analysis reflects any impact of our change from vertically integrated price controls to separate revenue controls for wholesale services.

9.5 Assessing net margin proposals

As with companies' proposed wholesale WACC(s), the key question we need to consider when assessing companies' proposed net margins is whether the returns assumed provide rewards to the company (and its investors) that are appropriate to the capital employed and risks the company is bearing.

Consequently, a key factor we need to consider when assessing proposed net margins is the level of risk associated with retail activities. As with wholesale controls our assessment of the level of risk will be informed by our scenario modelling, but we also need to consider two specific issues that impact on the level and volatility of retail risk:

- competition for non-household customers in England; and
- assumed payment terms between retailers and wholesalers.

In addition, and in contrast to wholesale WACC, we will assess retail margins on a pre-tax basis (EBIT) – and companies should take account of this treatment in developing their proposed margins.

9.5.1 Taking account of competition for non-household customers in England

For English companies, the two retail controls have fundamentally different characteristics – household retailers will remain monopoly suppliers, whereas non-household retailers will face competition both from each other and from new entrants.

This difference in competition risk alone suggests that different net retail margins are likely to be appropriate for the household and non-household controls of English companies. The different objectives of the two retail controls, and the different approaches we are taking to setting them, strengthen the case for separate net retail margins still further.

We have therefore decided that we should carry out separate assessments of net margins for the household and non-household retail controls of English companies.

For Welsh companies, our approach needs to reflect the fact that the vast majority of non-household customers will not be able to choose suppliers during 2015-20. We have already explained that we will reflect this significant difference by setting bespoke efficiency and service challenges for Welsh companies. But we also need to consider how best to reflect this difference in setting these companies' non-household net retail margins – as the scope for competition is a key driver of the volatility of risk faced by companies.

The very largest non-household customers of Welsh companies (those using more than 50 Ml/year of water) will continue to be able to choose suppliers. As such, we think it is appropriate that default tariffs for these customers are set consistently with those of English companies – so we will assess companies' proposed net retail margins for these customers in line with our assessment of non-household net margins for English companies.

But all other non-household customers of Welsh companies will not be able to choose supplier. As such, we think that it is appropriate to assess the companies' proposed net retail margins for these customers consistent with our assessment of household net margins for all companies in England and Wales.

9.5.2 Payment terms between retailers and wholesalers

We need to consider payment terms between the wholesale business and the retail business when assessing net margins because they affect retail (and wholesale) cash-flows, as well as any working capital costs that need to be funded via a net retail margin (versus remunerated in wholesale allowed revenue). They may also influence levels of risk and return for the wholesale business – particularly if they involve material changes to the current risks they face of non-payment by customers where there are wholesale service obligations.

For household retail and most non-household retail customers of Welsh companies, there is no scope for interactions with external retail entrants, so assumptions on payment terms will relate only to internal book transfers. But where non-household customers can switch suppliers, there may also be real transactions with third parties.

Such terms are therefore an important part of the retail market design for non-household customers in England, because these terms will provide certainty of access to that market by new entrants – who will want to understand these terms with certainty rather than negotiate them with a large number of incumbent wholesalers. Even in Wales, it will be important to establish standard payment terms for those very large non-household customers who are eligible to switch their retail supplier.

In addressing the issues around payment terms we need to consider:

- whether retailers pay wholesalers in 'advance' or in 'arrears' of services being provided;
- the billing and settlement period; and
- any credit terms (for example which retailers must meet).

In our methodology consultation we sought feedback from the Open Water programme on these issues. The Open Water programme informally consulted with market participants and there was no clear preferred approach.

Some thought that payment in advance was more appropriate because – although companies already face a risk of customer default now – payment in arrears would 'concentrate' that risk. They also noted that payment in advance could be simpler to administer because it would require no credit checking of entrants – and that this would incentivise retailers who were best placed to manage this risk. Others felt that payment in arrears was more appropriate because if payment was made in advance then it could create a barrier to entry.

There were also some acknowledged approaches to manage these risks such as changing the billing and settlement period or introducing credit terms.

On balance we consider that payment in arrears is more appropriate because:

- we do not consider that risk of retailer default 'concentrates' risk to the wholesaler; and
- we think that payment in advance could create a significant barrier to entry.

However, we also think that to minimise the impact on the wholesale business the billing and settlement period should be established as close to current arrangements as possible (that is, according to the average number of debtor days across the industry or similar). And we consider that some proportionate credit checks on new entrants will be required but these should not be unduly burdensome and we are seeking recommendations from the Open Water programme as to what these credit checks might be. We are similarly seeking recommendations around what approach should be taken if a counterparty presented a substantial credit risk – should there be some flexibility to these arrangements in those circumstances? We would envisage that these arrangements should be recommended by the Open Water programme by October.

We therefore confirm that:

- retailers should be required to pay wholesalers in arrears;
- there needs to be a consistent billing and settlement period across the non-household market which should be based on the current billing and settlement practise of incumbent companies to minimise any impacts on wholesale cash-flow and credit risk;
- retail entrants should be subject to proportionate credit requirements and consistent financial checks; and
- the detail on billing, settlement and credit requirements should be proposed by Open Water by the end of October.

This approach is broadly consistent with the approach used in Scotland, where new entrants can pay the wholesaler in arrears if they are able to produce a guarantee from an entity with an investment grade credit rating.

9.6 Risk and reward – risk-based review tests

In line with the discussion in the previous sections, we are also now confirming that we will use the tests set out in table 11 below when assessing risk and rewards as part of the risk-based review. These tests will be applied at the whole company level and the level of each plan element as appropriate.

Table 11 Risk-based review tests for risk and reward

Test	Key assessment criteria
Risk analysis	How far has the company provided sufficient information – including on company-specific risks – for us to analyse the impact of risks on consumers and companies? To what degree are the companies' proposed risk impacts within plausible and acceptable ranges?
Level and allocation of risk	To what extent do the different commitments and incentives within the price control elements of the business plan involve an efficient level and allocation of risk? In deriving these proposed allocations, has the company made appropriate assumptions in relation to the efficient mitigation of risk?
Rewards and returns	How well do the returns assumed in the company's business plan provide rewards to the company (and its investors) that are appropriate to the relevant risks the company is bearing for each element of its plan?
Retail net margins	Has the company proposed a reasonable household retail net margin? Has the company proposed a reasonable non-household retail net margin?

In assessing the reasonableness of companies' proposed margins, we will consider a range of factors. We will also make use of comparisons, including with other utility sectors.

For example, we would not expect a net margin that exceeded the typical ranges of retail margins in comparable utility sectors to pass this test, unless there is strong evidence of compensating benefits to customers. We would expect proposed margins to be consistent with payment terms between wholesaler and retailer.

9.7 Improving the opportunities for companies to manage risk

We explained in our methodology consultation that we are retaining a number of important features of our historic approach to price setting that help to mitigate overall risks for all affected companies in the sector, including:

- the use of the RCV for wholesale controls – which provides predictable, long-term returns on investment, and which we are now proposing to allow companies to use more flexibly in line with their own cash expenditure profiles;
- RPI indexation of wholesale controls and the RCV – which reduces companies' exposure to increases in input price risk (including the costs of index-linked debt, allowing continued choice over financing options); and
- Interim determinations – which allow companies to seek additional funding from customers before the next price review in the event of significant specific cost and (or) revenue shocks that are outside of management control.

We also explained that a number of the changes we were proposing to make to the way we set prices in future might impact on the balance of risk and the incentives used to reflect this balance, but that we expected the overall net impact of these changes to be small.

Having reached decisions on elements of the industry incentive package on which we consulted, we can now confirm that a number of changes to the regulatory framework should also improve companies' ability to manage risks. In particular:

- allowing more flexibility to adjust wholesale and retail revenues and charges within the control period will improve all companies' ability to mitigate the impact of unexpected changes in demand – as discussed in chapter 2;
- moving to an outcomes-focused approach to delivery will give companies more flexibility to find more effective or efficient solutions – and more scope to mitigate impacts on customers when risks crystallise (including via the specific delivery incentives they propose in business plans) – as discussed in chapter 4;
- moving from separate efficiency targets for capital and operating expenditure to totex-based cost performance incentives will give all companies more flexibility to manage changes in wholesale costs, and more opportunities to deliver value for money for customers over the longer term – as discussed in chapter 5;
- allowing all companies more flexibility to determine appropriate cost recovery rates will improve companies' ability to manage risks to financeability – as discussed in chapter 5;
- using an existing industry average as the basis for the initial efficiency challenge in household service provision in the next control period will mitigate risks associated with trying to estimate future efficient costs for each company when we first introduce separate caps on retail revenues – as discussed in chapter 6; and

- allowing companies the opportunity to earn greater rewards from trading will allow greater flexibility in managing supply/demand imbalances both in the next control period and beyond – as discussed in chapter 8.

At previous price reviews, we have also used a mechanism called the change protocol – which sets out a formal process for managing the risks and costs associated with in-period changes in companies' statutory obligations.

As we explained in chapter 4, we want companies' Boards to take more ownership of – and accountability for – what they deliver. This includes taking more responsibility for managing the risks associated with changes in statutory obligations.

We do not want to constrain companies by imposing a centralised process for managing changes in statutory obligations. Instead, companies should put forward proposals for dealing with such changes that reflect their customers' priorities and their own particular circumstances (which might include consideration of the level of uncertainty around obligations for 2015-20).

10. Delivering the right overall package

10.1 Overview and key decisions

In our methodology and business planning consultations we said that we would need to understand how all the elements of the different price controls worked together as an overall package.

This is because proposals for different price controls may come together in a way that – overall – has a significant impact on customers through bills or companies and the financing of their functions – and so have implications for the way that both Ofwat and the companies meet their statutory and legal obligations.

We therefore need to determine whether companies' proposals for 2015-20 are both **financeable** – for the company as a whole – and **affordable** for customers in the short and long term.

In this chapter, we confirm that we will assess financeability through the risk-based review for the company as a whole using aggregated revenues, costs and cash flows associated with regulated activities across all the price controls and that we will also assess whether individual controls are financeable in their own right by checking they allow sufficient returns to be self-financing over the longer term.

And we confirm our proposed approach to assessing affordability through the risk-based review, considering both short- and long-term affordability.

This chapter also sets out the final part of the overall price control package - the adjustments we need to make to price controls and revenues in 2015-20 to reward (or penalise) companies for their **performance in 2010-15**.

As part of our assessment of performance in 2010-15, we will allow companies to put forward specific proposals for investment in 2014-15 to deliver outcomes for 2015-20. Companies will bear the additional costs of financing this dedicated 'transition investment', and we will exclude the associated expenditure when determining incentive rewards and penalties under the CIS. This will ensure the transition between our current and future incentive frameworks does not disrupt efficient investment planning, and allow companies to bring forward investment plans where it is efficient to do so.

10.2 Financeability

As we set out in our methodology consultation, one of our statutory duties is to ensure that an efficient company can finance its functions, in particular by securing reasonable returns on its capital.

We explained in our methodology consultation that we interpret the financing functions duty as applying to the ring-fenced regulated activities of the appointee, and – consistent with our long held policies in respect of setting price limits – we interpret this duty to require that we would need to ensure an efficient company can:

- earn a return at least equal to our allowed costs of capital; and
- raise finance on reasonable terms.

We also explained in the methodology consultation, that our preferred approach to ensuring we met our duties was to:

- assess financeability (and financial ratios) at a whole company level – using aggregated revenues, costs and cash flows associated with regulated activities across all the price controls we set;
- check that – using these inputs and assumptions – companies' projected financial ratios are at levels which allow them efficiently to finance their functions; and
- assess whether the activities covered by the retail price controls are financeable in their own right.

There was broad support for our high-level approach in response to our consultation. But while most companies agreed that we should assess financeability at the whole company level, some thought that this would be best achieved by ensuring that all individual price controls were financeable.

In view of this, we confirm that we will assess financeability through the risk-based review for the company as a whole using aggregated revenues, costs and cash flows associated with regulated activities across all the price controls. We will look at a range of financial ratios and appropriate returns to check that companies' proposals are consistent with an efficient company financing its functions.

We will also assess whether individual controls are financeable in their own right. We will do this by checking they allow sufficient returns to be self-financing over the longer term. We will not assess financial ratios at an individual price control level – because this would be complex to calculate and would require a potentially arbitrary allocation of some balance sheet items. This focus on returns for specific price controls is consistent with the approach taken by Ofgem in the energy sector, and by Ofcom in the postal services sector.

We now provide more detail on the specific **measures of return** and **financial ratios** we will use in our tests and explain how we will look at financeability.

10.2.1 Measures of return

Return measures test whether a company's profitability is sufficient to remunerate the corresponding capital employed and attendant risks.

We have explained in chapter 9 that we will remunerate capital employed and risks using:

- a WACC return on RCV for wholesale controls; and
- a net margin for retail controls.

The WACC and net margin will be inputs into price control setting (that is, they will be used to help determine allowed revenues under the different controls). Our assumptions for the WACC and net margin will, by definition, need to be consistent with our assessment of the returns an efficient operator would need to secure finance on reasonable terms.

However, we recognise that under different scenarios and incentive outcomes, projected returns will vary in practice. We will therefore also need to consider – when assessing returns – both the impact of those scenarios and incentives, and the likelihood of those impacts.

We set out the return measures we will use – and why we think they are appropriate – in table 12.

Table 12 Return measures

Measure	Definition	Used for	Rationale
Return on capital employed (ROCE)	Return due to providers of finance (EBIT − tax)/RCV	Wholesale controls (both water and wastewater)	Reflects capital intensive nature of wholesale activities Allows assessment of overall returns against the WACC
Return on regulatory equity (RORE)	Return due to shareholders/equity component of RCV assumed in notional capital structure Return due to shareholders calculated as EBIT − tax − (cost of debt × average net debt)	Wholesale controls (both water and wastewater)	Allows assessment of returns earned by equity providers against the assumed cost of equity
Retail net margin	EBIT (as % of end retail revenues)	Household retail control (also an input for setting controls on default tariffs)	Low level of capital expenditure in retail means measures based on return on capital are inappropriate Allows retail profitability to be assessed against 'allowed' retail net margins

10.2.2 Financial ratio measures

In principle, if efficient operators can earn 'reasonable' returns over a price control period on component parts of the appointed business, their overall financeability should also be secure. In practice, however, financeability challenges can still arise from 'timing mismatches' between required and actual cash flows within individual years. And as part of our risk-based review tests, we will look at the financeability of companies' business plans to safeguard the interests of customers and ensure companies' proposals represent a fair balance between them and customers.

The financial ratios we have used in previous price reviews are those typically reviewed by credit rating agencies for testing credit risk and the risk of default on debt. These are shown in table 13.

Table 13 Financial ratios previously used to review financeability

Measure and definition	Notes
Cash interest cover (Funds from operations)/(Net interest)	Measures the ability to meet interest payments from operational sources of cash generation – and given industry capital structures is considered to be a key financeability metric by ratings agencies.
Adjusted cash interest cover ratio (Funds from operations – capital charges)/(Net interest)	Similar to cash interest cover, but measures the scope to make interest payments after capital charges (the 'depreciation' charges described in section 5.4 above). It is a more conservative measure than cash interest cover (in particular, it provides an indication of coverage assuming companies could not reduce capital charges).
Funds from operations/Debt	Measures companies' debt burden in relation to operational income.
Retained cash flow/Debt	Assesses companies' ability to repay (rather than service) debt.
Gearing (Net debt)/(RCV)	Measures the capital structure of companies and is therefore critical to the assessment of financeability.

We have reviewed these measures, and remain of the view that they are appropriate. We will therefore continue to use these financial ratios for 2015-20.

As in previous price controls, we will take a flexible approach to financial ratios. We will take decisions on the appropriate 'levels' for these ratios, and their relative importance, when we review companies' plans. These decisions will be informed by discussions with the ratings agencies and financial markets.

We will also take into consideration further ratios, which are more relevant to equity investors (see table 14).

Table 14 Equity ratios

Measure and definition	Notes
Dividend cover (Profit after tax)/(Dividends paid)	Provides a measure of the long-term ability to pay dividends. Although changes in dividend cover from year-to-year do not provide a strict measure of financeability, companies do need to ensure a dividend cover of >1 over the longer term. We take the view that it is for companies to determine a dividend policy appropriate to their circumstances.
Regulatory equity/Regulatory earnings for the regulated company	This ratio (which is also used by Ofgem) provides a measure of the value of the equity component of the RCV relative to the level of companies' earnings. It can be used to provide an indication of whether earnings are likely to be consistent with providing acceptable returns to equity at prevailing regulatory equity values. Regulatory earnings are calculated by debt interest and tax expenses from EBIT. Regulatory equity is calculated as the RCV multiplied by the equity proportion in the notional capital structure.
RCV/EBIDTA	This measure provides information on the operating cost structure that allows comparison of the sustainability and trend of earnings across companies. It is relevant for both and equity investors.

These equity ratios provide an indication of companies' long-term ability to generate equity returns (and relatedly, raise equity). However, it is less critical for companies to achieve certain levels in relation to these measures on an annual basis.

Consequently, we do not think it is appropriate to set specific target levels or ranges for equity ratios; but, rather, we propose simply to review them as part of our wider financeability assessment. This is consistent with Ofgem's approach in the energy market.

10.2.3 Addressing financeability constraints

Companies will need to consider potential financeability constraints as part of their business plans – and put forward appropriate proposals to mitigate any such constraints. In doing so, we expect companies' Boards to ensure that they have shown in their plans that they have:

- accurately identified the underlying cause of any constraints;
- taken account of all appropriate factors in deciding whether to take steps to mitigate the constraints; and
- identified the appropriate tool(s) to address the constraint.

Efficient companies have a range of options available to them to resolve financeability constraints. These include changes to other aspects of their business plans, such as:

- with the exception of outcomes related to statutory obligations, reducing or re-profiling outcome commitments – and associated expenditure (particularly where substantial capital expenditure has a detrimental impact on short-term financeability ratios);
- changes to cost recovery assumptions – such as RCV run-off rates and PAYG ratios; and
- changes to revenue profiles over 2015-20.

Companies may also make use of market mechanisms to manage financeability constraints. For example, companies could choose to use equity injections or equity retention (reducing dividends). If financeability constraints are caused by the inflation wedge between debt raised in nominal terms and costs set in real terms – and subsequently indexed to RPI – then indexed-linked debt may provide a solution.

Companies will need to demonstrate clearly why their proposed approach to addressing financeability constraints is the most appropriate to their particular circumstances. They will also need to show that their proposed approach is feasible, and strikes an appropriate balance between the interests of companies' investors (including debt providers) and customers.

In particular, companies will need to demonstrate how they have balanced short-term benefits to financeability against the costs to customers and the risk of creating more serious financeability constraints in the longer-term.

10.3 Financeability – our risk-based review tests

We explained in the methodology and business plan consultations that we would assess and challenge the financeability of companies' proposals as part of the risk-based review. We also said that the key factors we would need to consider included:

- the risks the company faces, the remuneration assumed for those risks, and the financing assumed consistent with such remuneration;
- the financial indicators the company is using to assess its financeability, including how they relate to the company's proposed credit rating and the price controls assumed in the company's business plan; and
- the sensitivity of these indicators to companies' proposed key risk drivers (including relevant company-specific risk drivers), by looking at the impact of relevant scenarios (described in section 3.3) on the company's financial performance.

As no respondents raised significant objections to the key factors we proposed considering or our proposed tests, we confirm the final risk-based review tests will be those set out below in table 15.

Table 15 Risk-based review tests for financeability

Test	Key assessment criteria
Financeability	Taking account of assumptions on costs, revenues, risks and capital structures, how clear is it that the company, if efficient, will be able to finance its functions? How clearly do the company's proposals for each control allow sufficient returns to be self-financing, if it is efficient, over the longer term? To what degree do the company's proposals represent a fair balance between the company and customers?

10.4 Affordability – our risk-based review tests

In the business planning consultation, we explained that our preferred approach to assessing affordability was focused on the impact on customers' bills over time, including beyond 2015-20. We proposed to include a test for affordability in the risk-based review, which considered both:

- affordability over 2015-20; and
- affordability over the longer term – including an assessment of how well the company has demonstrated it has explored all options to ensure longer-term affordability.

Respondents did not comment specifically on our proposed risk-based review test for affordability, but some did raise separate, specific issues – suggesting, for example, that our affordability and financeability tests should be kept separate. We have considered these issues and decided to confirm our proposed approach to assessing affordability through the risk-based review, of considering both short- and long-term affordability.

We will do so using the criteria set out in table 16. These tests will be applied at the whole company level and the level of each plan element as appropriate.

Table 16 Risk-based review tests for affordability

Test	Key assessment criteria
Affordability	How well has the company demonstrated that its proposals are affordable over 2015-20 and that it has used appropriate means to secure the affordability of bills for customers? How clear is it that the company's proposals are affordable in the longer term? How far has the company demonstrated that it has explored all possible options to ensure that this is the case, for example, by the way it has set out its cost recovery proposals?

10.5 Reconciling performance in 2010-15

We explained in our methodology consultation that, when we set price controls for 2010-15 at PR09, we included a number of incentive tools (see table 17) designed to:

- manage the risks to customers and companies from uncertainty in costs and changes in the outputs companies deliver; and
- provide incentives to encourage efficiency and outperformance, and penalise companies that perform poorly.

Table 17 PR09 legacy incentive tools

Tool	Purpose
Service incentive mechanism (SIM)	Incentive to reward good customer service performance.
Revenue correction mechanism (RCM)	Tool to deal with differences between actual revenue collected and our assumptions for allowed revenue at PR09.
Opex incentive allowance	Balancing incentive for savings in operating expenditure designed to counter effect of five-year price controls.
Capital expenditure incentive scheme (CIS)	Incentive used for capital expenditure, designed to reward both cost outperformance and accurate business plans.
Change protocol (logging up and down, shortfalls, overlap programme)	Tools used to deal with material changes in delivery from our assumptions at the 2009 price review.

We confirmed that – as part of the 2014 price review – we would use these legacy tools to compare actual performance, costs and revenues against the assumptions we made at PR09. Where appropriate, we would then make adjustments to allowed revenues (and price controls) for 2015-20 to reflect companies' outturn positions.

We also confirmed that we will need to make adjustments to:

- account for differences between the RCV projections we made in 2009 and companies' outturn positions;
- recover any assumed costs of issuing new equity during 2015-20 where these costs did not materialise (this only applies to the small number of companies we assumed would need to issue new equity); and
- recover any tax benefits arising from in-period changes in capital structures.

We did not seek specific comments on these individual tools in the methodology consultation, and respondents have not raised any issues which cause us to change our view about whether we should apply each tool. As a result, our position on legacy tools remains unchanged – we will use them to assess companies' performance over 2010-15 and, where appropriate, make adjustments to revenues and price controls for 2015-20 which reflect that performance in line with our commitments at the previous price control.

10.5.1 Performance in 2010-15: consideration within risk-based review

We sought views from stakeholders on how we should implement any adjustments arising from the legacy tools. Our preferred approach was to make all adjustments through wholesale controls for 2015-20 – because most legacy tools map to activities covered by wholesale controls. We also proposed to make adjustments for SIM performance to wholesale controls, because it would be too complex to split adjustments across household and non-household retail controls.

We explained that we wanted to keep open the option of spreading adjustments across more than one year of the price control period – and noted that any such decisions should be revenue neutral.

In the business planning consultation, we developed this idea further – explaining that we wanted companies to propose appropriate adjustments for 2010-15 performance in their business plans within these parameters. We would then review and challenge companies' proposals as part of the risk-based review – using tests which looked at whether companies had:

- presented a fair and accurate account of their actual and projected performance over 2010-15; and
- proposed adjustments to 2015-20 price controls that fairly reflected their performance and were calculated in line with our guidance.

A small number of companies suggested that performance in 2010-15 should have a greater impact on our assessment of business plan quality – and be part of the main risk-based review tests.

Our risk-based review is a test of the overall quality of the business plan. So while we do intend to take a risk-based approach to challenging companies' proposals, historic performance is not a key test to determine the quality of the overall plan. (Although, as we explained in chapter 3, a company with poor historic performance or delivery issues in a particular area will need to demonstrate clearly that its proposals are credible in the light of those issues.) So we confirm that we expect companies to propose appropriate adjustments in their business plans, which we will then consider as set out in table 18 below.

Table 18 Other considerations

Area	Consideration
Actual performance	How fairly has the company reflected its actual and projected performance in 2010-15? How consistent is the company's reported and projected performance with: • its risk and compliance statements and published key indicators? • other companies' reported performance (where relevant)?
Adjustments to 2015-20 price controls	How clear is it that the company has calculated any adjustments to 2015-20 price controls in line with our guidance and tools? How fairly do the company's proposed adjustments to 2015-20 price controls reflect its performance in 2010-15?

Consistent with the overall approach to business plan assurance set out in chapter 3, we expect companies' Boards to sign off their statements of actual performance over 2010-15 – and any proposed adjustments to 2015-20 price controls.

All respondents that commented agreed with our proposed approach of making adjustments to wholesale controls and we confirm that we will implement all adjustments from legacy tools through wholesale controls for the reasons set out in our consultation and summarised at the start of this section.

Respondents were also broadly in favour of spreading adjustments across more than one year – with some suggesting that smoothing over the entire five-year period would be best for customers. Several companies suggested we should have regard to maintaining company financeability when taking decisions on spreading adjustments.

Taking into account these comments, we confirm that we will keep open the possibility of spreading adjustments across more than one year, with companies:

- suggesting how these adjustments should be applied in their business plans; and
- having the opportunity to make representations on how adjustments should be applied between draft and final determinations once the scale of such adjustments are made visible at draft determination.

We have already published spread sheet models that set out how we will calculate adjustments arising from the RCM and CIS, which should allow companies to propose appropriate adjustments to reflect performance in 2010-15 in their business plans. But companies also sought clarity on a number of other legacy incentive tools, which we now consider in more detail.

10.5.2 Service incentive mechanism (SIM) for 2010-15

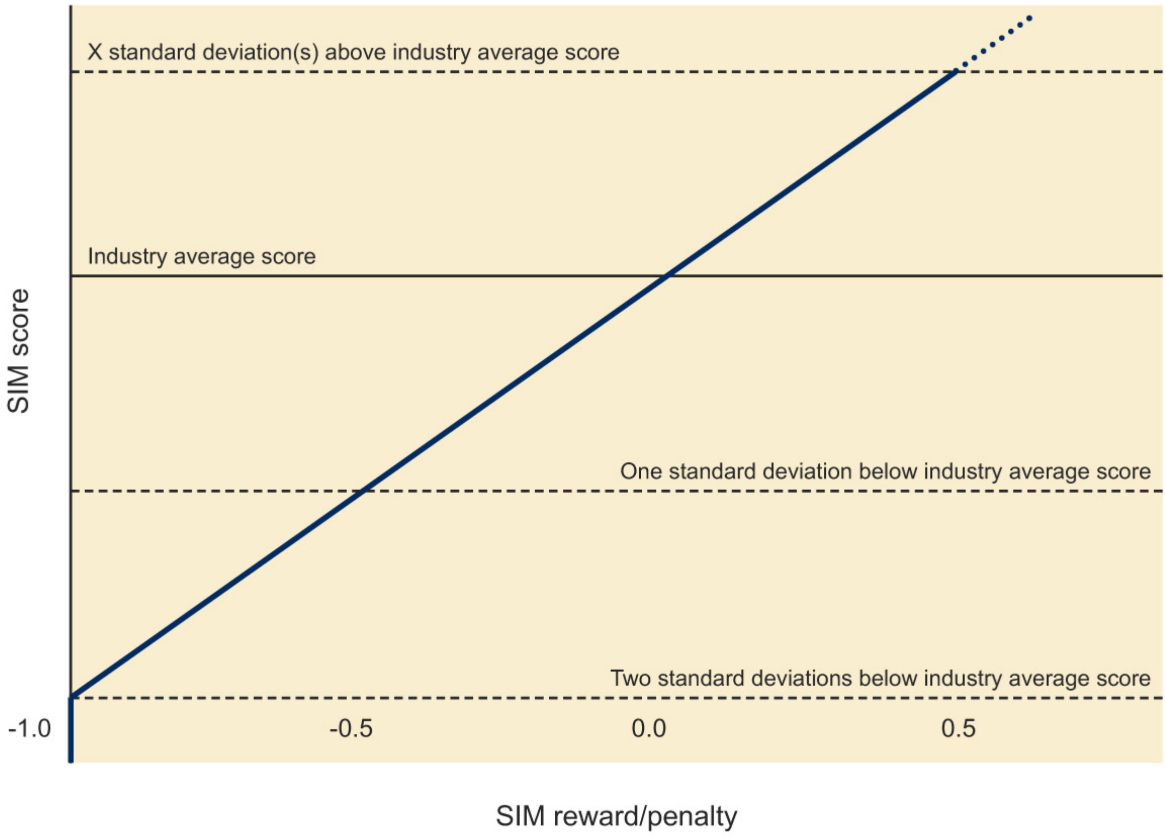
The SIM is a comparative incentive mechanism that assesses companies' relative customer service performance.

For 2010-15, it uses data from the three years 2011-12 to 2013-14 to apply rewards and penalties in the range of +0.5% to -1.0% of company regulated turnover. We explained in our methodology consultation that we intended to publish our approach to (and quantification of) SIM rewards and penalties with the draft determinations – as this would allow us to use data from all three years.

After we published the published the methodology consultation, a number of companies sought earlier clarity on how we may apply SIM rewards and penalties so they can factor this into their business plan submissions. We appreciate that this would be helpful for companies, however, we are also mindful of the need to maintain the incentive properties of the SIM, and so while we give more detail below, this is an outline only – so as not to reveal the result to companies, potentially dampening their incentives.

In making our decisions on rewards and penalties for SIM, we will assess companies' performance relative to the industry average. Figure 8 sets out an illustrative example of what this might mean based on first year SIM performance data. It assumes that the maximum penalty of -1.0% of turnover would apply to performance of a given deviation below industry average and the maximum reward of +0.5% of turnover would apply to performance of a given deviation above it.

Figure 8 Illustrative approach to setting SIM rewards and penalties for 2010-15 (based on 2011-12 data)



We will publish company performance for 2011-13 (and potential illustrative rewards and penalties based on that data) in September 2013. We consider that this will enable companies to make informed decisions on the potential application of rewards and penalties for the SIM, and to factor these into their business plan submissions.

Our views on the full three years' worth of data will be published as part of the draft determinations in the summer of 2014, allowing companies to make representations prior to final determinations.

10.5.3 Opex incentive allowance

The operating expenditure incentive allowance mechanism was introduced at the 1999 price review to recognise the full incentive effect of operational savings – regardless of when the savings are made. Savings are retained and 'rolled up' into price controls for the following price control period as long, as the savings result in sustained operating cost reductions. This mechanism dealt with the timing distortion of price reviews on operating cost incentives.

For the 2004 price review, we supplemented the operating expenditure incentive allowance with an enhanced outperformance multiplier. This was designed to recognise the wider benefits to customers of all companies that occur when the most efficient (frontier) companies deliver further operational efficiencies – and to strengthen incentives on frontier companies to deliver further efficiency savings.

We published this approach as part of the 2004 final determinations, along with the specific companies who would be eligible, and the scale of multipliers which would be applied. Our 2009 final determinations then explained how we had reconciled and implemented enhanced outperformance multipliers in line with company performance over 2005-10.

After we published our methodology consultation a number of companies sought clarity as to whether we also expected to use some form of multiplier for the opex incentive allowance during 2010-2015. Our 2009 final determinations did not specify the use of any enhanced multipliers for 2010-15.

In line with the move away from separate assessments of operating and capital expenditure explained in chapter 5, we will apply the opex incentive allowance at PR14 **without** enhanced multipliers. Efficiency savings over 2010-15 which result in sustained reductions in operating costs will be retained and 'rolled up' into price controls for 2015-20 in the same manner for all companies.

The opex incentive allowance will then be discontinued as an ongoing incentive framework for future control periods – it is not relevant as we move to assessing cost on a totex basis.

The move to totex also has implications for other historic adjustments, for example some licences still contain a retained Relevant Change of Circumstance condition – 'RCC(4)' – that allows a company (and Ofwat because it is symmetrical) to apply for an IDoK in the event that construction price inflation materially differs from our assumptions at the previous price control determination. The clause relies on Ofwat setting a projected capex allowance at final determination. However, implementing totex means that we will neither set a capex allowance nor use COPI as would be relevant for RCC(4).

10.5.4 Change protocol, logging up/down and shortfalling

The change protocol – and associated tools such as logging up, logging down and shortfalling – is the mechanism we have used over 2010-15 to manage changes in the outputs companies deliver, and to encourage long-term sustainable investment.

We expect companies to set out and demonstrate how they have delivered their PR09 final determination outputs and obligations for 2010-2015, incorporating final adjustments and reconciliations for outputs in 2009-10. Where the companies have not delivered, or are at significant risk of not delivering, these outputs we would expect the company to suggest appropriate shortfalling and logging down. Similarly, where a company has had to deal with appropriate (and non-trivial) new obligations, it should consider these for logging up.

This approach applies across all PR09 outputs – including those in relation to serviceability. In particular, we expect companies to propose appropriate shortfalls if they are projecting 'marginal' or 'deteriorating' serviceability for any subservice in 2013-14 or 2014-15.

Companies should include details of their proposals for logging up, logging down and shortfalling in the appropriate data tables (W13 and S13). In line with the approach to business plan assurance set out in chapter 3, we expect companies' Boards to put in place whatever assurance processes they require in order to confirm the data submitted is accurate and complete.

10.5.5 The overlap programme

The overlap programme was a mechanism we used at PR09, designed to prevent inefficient investment across the transition between the 2010-15 and 2015-20 price control periods. It is limited to 14 pre-agreed schemes (across companies in England and Wales) which span the transition between price control periods.

As we set out in the methodology consultation, we will reconcile any investment undertaken within this overlap programme in line with our commitments at PR09. We have included specific data tables (W14 and S14) to capture information on the progress and future expenditure forecasts for the schemes included in the overlap programme.

10.5.6 Transition investment

Some companies want to bring forward planned investment from 2015-20 into 2014-15, in order to make more efficient use of resources and the supply chain. Under our current approach this investment would be reconciled as part of the CIS as it would be incurred within the 2010-15 period and the company would incur a penalty.

In responses to the methodology consultation, some companies argued that this treatment would distort efficient investment planning decisions, as it disincentivises bringing forward investment into 2010-15 – even where it is efficient to do so.

We accept that regulatory incentive tools designed to encourage efficiency should not distort companies' longer-term investment planning decisions.

A number of companies proposed the following solution to the issue in their consultation responses:

- Companies' business plans identify specific transition expenditure that would be more efficiently incurred at the end of 2010-15 to deliver outcome commitments (such as new statutory requirements) during 2015-20;
- Companies fund any associated financing costs of transition expenditure; and
- We exclude this transition expenditure from the CIS capital outperformance 'true-up' for 2010-15, and instead take account of it in assessing the expenditures required for delivering 2015-20 outcomes.

We accept that such a proposal would avoid the risks to efficient expenditure associated with changing regulatory frameworks at the end of the current control period, while avoiding any additional impact on customers' bills.

We have therefore decided that companies may put forward proposals for specific transition expenditure during 2014-15 in their business plans, which we will consider. We will not restrict the areas of capital of expenditures that companies can propose for this purpose. We have included two additional data tables (W3a and S3a) for companies to provide relevant information.

In line with the approach to business plan assurance specified in chapter 3, we would expect Board to determine the appropriate assurance they need to ensure they are able to confirm the purpose and effect of any proposed transition investment.

For the price review in 2019, when in principle a similar issue may arise in relation to longer-term outcome delivery and expenditure planning, there may be less need for prescribed transitional mechanisms, as our outcomes and totex regulatory frameworks are aimed at encouraging longer-term planning, and investment aimed at minimising whole life cost.

However, we will examine any specific proposals in business plans for addressing such risks in future, and continue to be mindful of the need to incentivise longer-term investment where appropriate in future price reviews.

11. Revealing information

11.1 Overview and key decisions

Overview of our approach

We explained in our methodology consultation that we expect to continue adapting and evolving our approach to price setting to take account of changes in the water and sewerage sectors. For example, we might need to change our approach in response to new legislation (such as that envisaged by the UK Government in the Water Bill), or to reflect the development and evolution of markets (for example, in retail or in water resources).

We want to take steps in the next price control period to improve the way we regulate companies' monopoly network when we next set prices in 2019, through the phased introduction of two new tools:

- **network plus** – designed to reveal information about costs and revenues related to companies' network and treatment activities; and
- **network management** – designed to reveal information about companies' network management policies, practices and cost drivers.

We have decided to confirm our consultation proposals for network plus, and will introduce **two non-binding sub-limits** within the 2015-20 period:

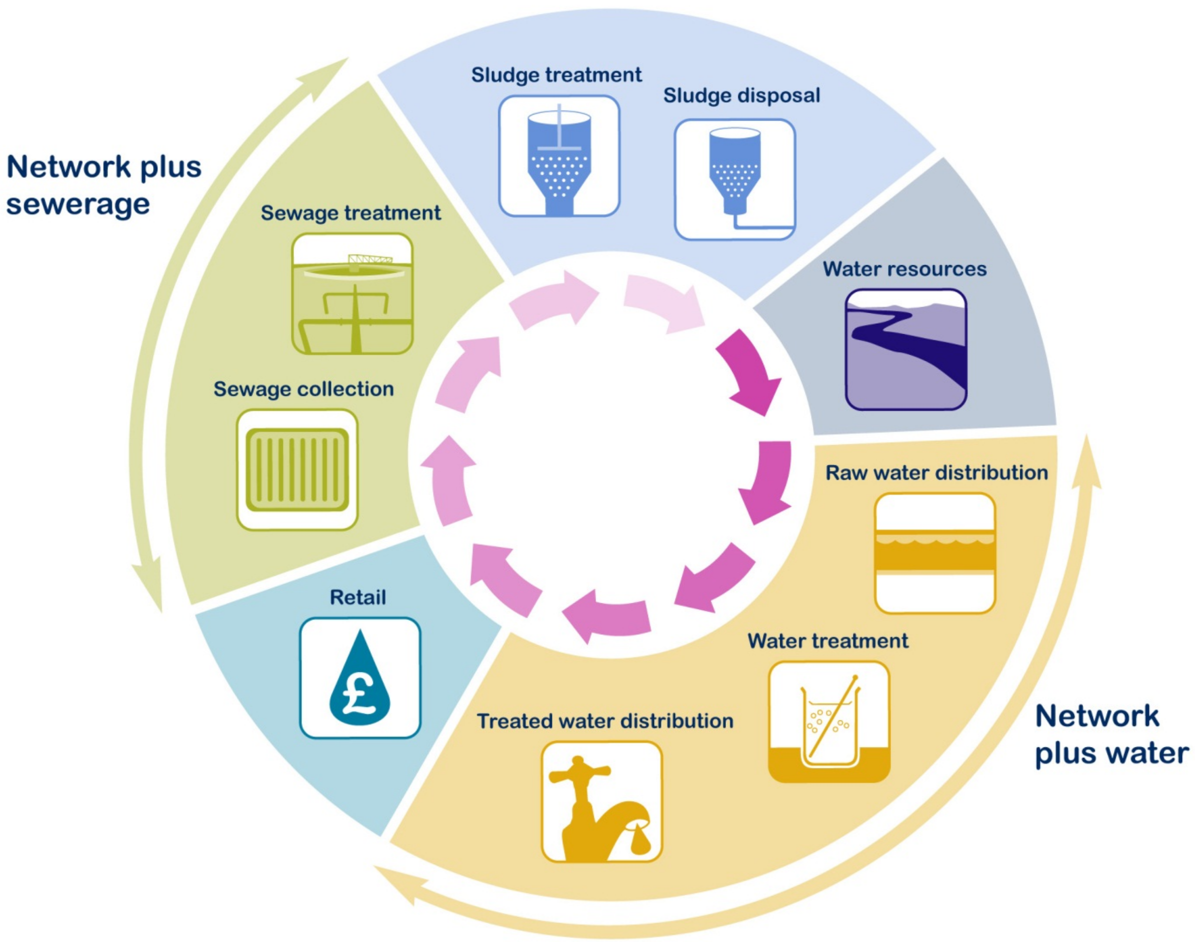
- one for water, covering raw water distribution, water treatment and treated water distribution, but not water resources; and
- one for sewerage, covering sewage collection and sewage treatment, but not sludge treatment, recycling and disposal.

We have decided to introduce network management reporting for water networks and sludge gradually over 2015-20, and will decouple this from the price review, although we may still trial an incentive later in the price control period.

11.2 Network plus

The intention of network plus is to set non-binding price controls for companies' core network and treatment activities. In the methodology consultation, we explained that our preferred approach was to set two non-binding sub-limits, aligned to existing accounting separation business units (see figure 9).

Figure 9 Scope of network plus sub-limits



We also explained that we wanted to introduce network plus gradually, building on accounting separation to introduce both separated revenue accounting and non-binding sub-limits by no later than 2017-18.

Respondents generally agreed with our proposed scope and phasing of network plus, and welcomed our recognition that this work needed to be aligned with future reforms to access pricing and the timetable for implementing the changes envisaged in the forthcoming Water Bill. Nevertheless, several companies queried whether indicative sub-limits would deliver additional benefits over and above those delivered by separate revenue accounting.

Trialling indicative sub-limits is an important step to possible reforms at the next price review, and will align with our work with the Open Water programme. They should provide greater transparency on both costs and revenues associated with network activities. They will help enforce robust cost allocation between areas with greater natural monopoly characteristics and potentially more contestable activities, which is essential to facilitate effective competition. They also allow us to tailor our approach to regulation for different parts of the value chain – including, where appropriate, facilitating deregulation – and will ultimately deliver more efficient prices for services that are potentially contestable.

We have therefore decided to confirm our consultation proposals for network plus, and will introduce two sub-limits during 2015-20:

- one for water, covering raw water distribution, water treatment and treated water distribution, but not water resources; and
- one for sewerage, covering sewage collection and sewage treatment, but not sludge treatment, recycling and disposal.

Our methodology consultation also discussed whether additional cost allowances should be made to allow companies to introduce network plus. In general, respondents questioned whether such allowances would be necessary given that network plus would involve an extension of existing arrangements for separate accounts.

In the light of this feedback we do not intend to introduce a specific cost allowance for network plus, but will consider whether we can develop financial incentives for the provision of high-quality information, including in relation to network plus (see section 11.4).

We will continue take a measured approach to implementing network plus, developing separate reporting of costs and progressing to revenue reporting and then the setting of indicative sub-limits by no later than 2017-18. This will be taken forward as part of our work on the regulatory accounting guidelines

11.3 Network management

The network management initiative is designed to encourage companies to provide information about their approach to managing their networks. Over time, high-quality information in respect of these matters should encourage the better management of networks, help managements make better informed decisions about network use and development, and, support the non-discriminatory treatment of other users of the network.

We explained in our methodology consultation that:

- our preferred scope for network management reporting covered both water networks and sludge;
- we proposed to introduce network management reporting gradually, with companies responding to an initial round of open questions in their business plans; and
- we proposed to keep open the option of introducing non-binding targets or incentives for network management towards the end of 2015-20.

Respondents generally agreed with our proposed scope and phasing of network management reporting, but a small number of companies expressed reservations about implementing these proposals. In particular, several companies expressed concerns about the relatively tight timetable for PR14, and felt that information relating to network management should not be included in the requirements for business plans and that we could develop our proposals further following the price review.

In the light of this feedback, we have decided to simplify our requirements for network management reporting in 2014.

- Where companies have information that is reasonably available they should separately identify network management costs, either on the basis of the incremental costs of planned new systems, or, the costs that they can reasonably attribute to these activities as part of business plans – but there will no obligation at this stage for them to develop new plans in relation to network management or provide information that is not readily available.

- Draft questions indicating the direction of travel on network management are included in appendix 4 for information only at this stage; we will request further detailed information from companies on network management and agree a detailed timetable for this work following our review of business plans.

Nonetheless the objectives for network management for the longer term remain important and so we confirm the overall vision for 2015-20, with the network management initiative informing:

- best practice in relation to network management;
- other users of the network about the network management processes that they will encounter;
- our decisions on whether it is appropriate to introduce incentives for efficient network management when we next set prices in 2019; and
- decisions on what we should incentivise and the appropriate level of any incentives.

We will need to consider how best to deal with any costs associated with new network management obligations during 2015-20. In other regulated sectors, regulators have proposed packages of new regulatory obligations, incentives and cost allowances during a price control period. Companies can then decide whether to accept the proposed package, with scope for a reference to the Competition Commission if agreement cannot be reached.

We do not think we can take this approach, as it is not consistent with the present drafting of water and sewerage companies' licences. Therefore, we will need to adopt a different approach – this could involve considering what incentives (and where necessary extra allowances for costs) would be appropriate during the period 2015 to 2020 and, if companies were to agree to such arrangements, then implementing the incentives within the period of the price control, but making the financial adjustments to take account of performance and any agreed allowances for costs at the next price review.

In summary we are confirming the broad approach to network management set out in the methodology consultation:

- we will introduce network management reporting for water networks and the wastewater networks relevant to sludge; and

- we will introduce reporting gradually, evolving from initial open questions to consistent reporting (including cost drivers), with an option to set a trial incentive later in the price control period.

However, we are delaying the start of further substantive work on network management until after we review business plans for setting 2015-2020 price controls. We will also seek to make any allowances for additional costs to match new obligations on a pragmatic basis. This in part reflects stakeholder feedback, and the need to focus on business planning and the price review control review during the remainder of 2013 and 2014. But it also reflects our view that – given the importance of network management reporting – we should take more time to engage with companies before implementation.

11.4 Incentives for providing information

We explained in our methodology consultation that we were considering using incentives to encourage companies to report high-quality information for both network plus and network management.

In particular, we suggested making an allowance for specific additional costs of high-quality reporting when we set prices in 2014, which would be clawed back if companies failed to provide information of sufficient quality to support the benefits we are seeking for future consumers. As we have explained earlier in this chapter, we have changed our position. We do not intend to make an extra specific allowance for network plus costs, and we will consider network management costs and obligations following the review of business plans to set price controls.

Nonetheless, we will also give further consideration to whether incentives can be developed to encourage the provision of high-quality information, either during the price control review, or as part of the on-going work on network plus and network management.

12. Business planning expectations

We want to step back from the detailed and prescriptive business planning guidance we have issued for previous price reviews, and focus instead on the key information and data we will need to set price controls. This should help us deliver a targeted and proportionate price setting process.

So, we confirm our proposal that companies should provide an overall business plan narrative that explains their proposals for 2015-20, and how they arrived at them – and it will be for companies' Boards to determine the best way to present their proposals – we do not want to constrain companies' approaches by issuing prescriptive guidance or templates that they should follow.

Of course, it will be important that business plans and the narrative provide a persuasive vision for the future which is supported by compelling evidence. A company that submits clear, well-reasoned evidence – which is in a form accessible to us, customers, CCGs, and other regulators and stakeholders – will be more likely to have its proposals accepted than a company that does not.

We confirm that companies should provide a common set of supporting data tables and associated commentaries alongside their business plan narratives – and alongside this document we publish our final data table requirements. In setting out the data that we need, we have been careful to make sure that we specify the right amount of data – which is all the data we need to set price controls, but not more than we need.

The risk-based review set out in chapter 3 is a key part of delivering a more proportionate and targeted price setting process. We confirm that companies with very high-quality plans, which qualify for the enhanced category, can expect a reduced data burden compared with previous price reviews. But we may need to require additional information and data from companies with poorer quality plans.

12.1 Business plan narrative

In the business planning consultation, we set out our high-level expectations for companies' business plan narratives, explaining that they should:

- provide a full explanation of companies' proposals, covering the four key areas we will assess in the risk-based review – outcomes, costs, risk and reward, affordability and financeability;
- set out companies' proposals separately for each price control, as well as – where necessary – for the company as a whole; and
- be accessible to customers, CCGs, other regulators and company employees and stakeholders, not just us.

While some respondents recognised our proposed approach would hand back ownership of business plans to companies, several companies sought more guidance on our expectations for business plans – and suggested this would help them deliver better business plans.

We remain of the view that – in the context of our objective of giving company Boards ownership of, and accountability for, their proposals – companies should be given freedom to construct and present their business plan narratives in the way that best fits their customers' priorities and their particular circumstances and so we confirm our proposals. So we will not be issuing detailed guidance on the business plan narrative. We also confirm the high-level guidance we set out in the business plan consultation (table 19).

Table 19 High-level guidance on business plan narratives

Companies' business plan narratives should provide a full picture of their proposals, covering the four key areas we will assess in the risk-based review.

- **Outcomes** – what the company is proposing to deliver for consumers (including current and future customers and the environment) , including how:
  - it has engaged with customers in developing its proposals – and how those proposals reflect customer views and priorities;
  - its proposals deliver the best long-term, sustainable solution for consumers (including current and future customers and the environment);
  - its proposals include appropriate incentives to secure delivery and value for money for customers; and
  - it has met, and intends to meet, its statutory obligations.
- **Costs** – the company's proposed costs for delivering its outcome commitments, including how these proposals reflect the efficient cost of delivery.
- **Risk and reward** – the company's approach to risk and reward, including how it has determined:
  - an efficient distribution of risk between customers and the company; and
  - returns that provide appropriate rewards for the level of risk it is bearing.

- **Affordability and financeability** – the impact of its proposals on customers' bills, and on the company (and its investors). We would expect this to include discussion of the companies' approach to financing long-term investment.

Companies' business plans should set out their proposals separately for each price control, as well as for the company as a whole where necessary – for example, for affordability and financeability.

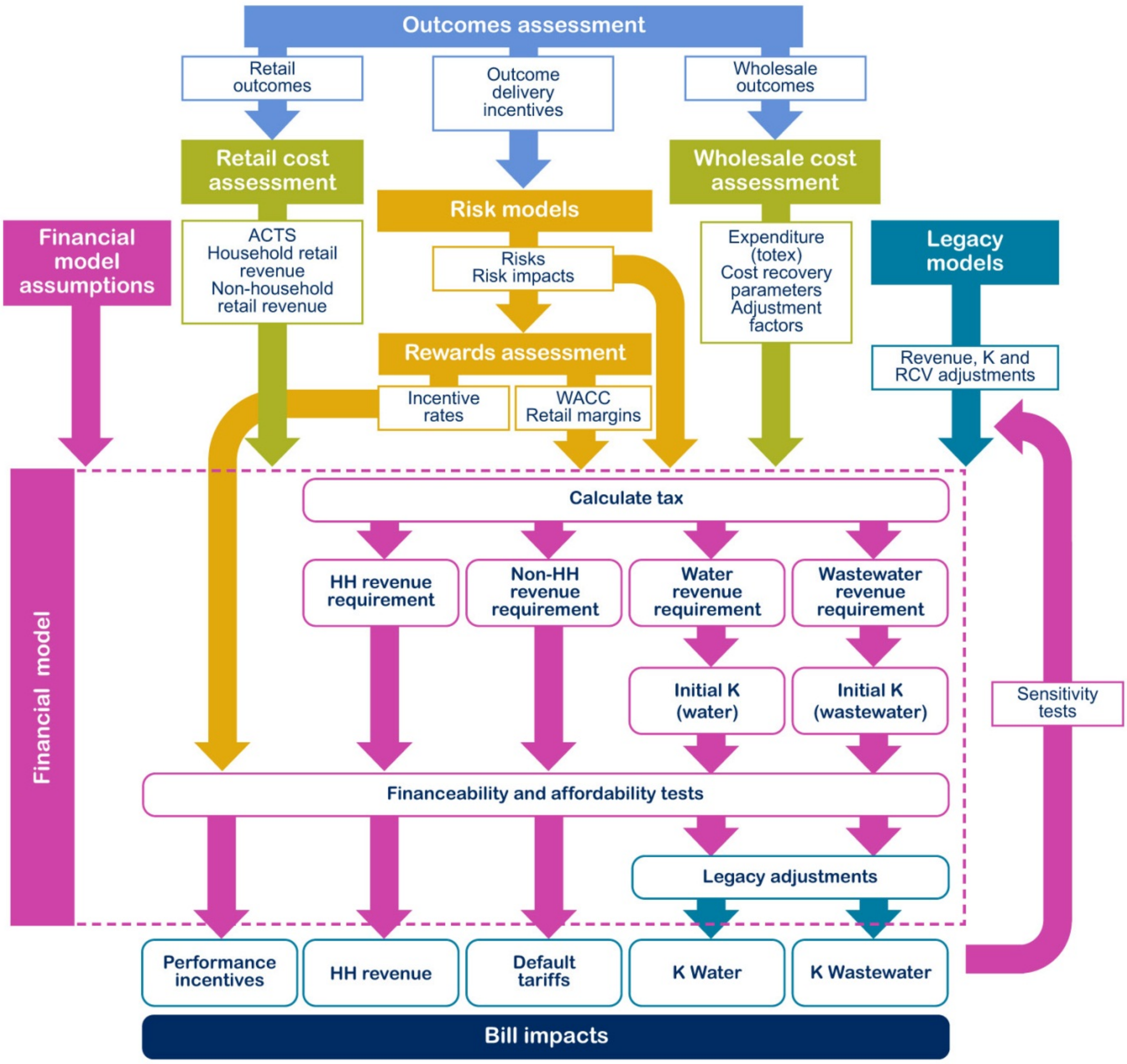
The business plan narrative – and the business plan as a whole – should be accessible to us, to customers, to CCGs, and to other regulators and stakeholders.

12.2 Supporting data tables

We explained in our business planning consultation that we wanted to deliver focused information requirements – ensuring we collected all the data we need to set price controls, but no more than we need.

We set out a total of 63 draft data tables (19 for water wholesale, 19 for wastewater wholesale, 5 for retail, and 20 at a whole company level). We explained that these tables were designed to collect all the data needed to carry out our risk-based review and to run our financial modelling – as well as allowing us to carry out a range of assessments which both supported the risk-based review and determine some inputs to the financial modelling (figure 10). We acknowledge the advantages of a transparent process. We intend to publish our financial model during the price review.

Figure 10 Approach to analysis



Respondents made a range of detailed comments on our draft data tables, which we have taken into account in revising and finalising the supporting data tables. In particular, we have:

- revised our tables on **ODIs** to reflect companies' suggested simplifications;
- clarified our approach on the **cost of capital** and on **new capital expenditure in retail**;
- made some scenarios optional **in the scenario table**, and built in greater flexibility to allow companies to show two more company-specific scenarios if they wish;

- added tables on **transition investment** to collect information on early expenditure in 2014-15;
- added an additional table to collect data about the **level and cost of debt** on companies' balance sheets at 31 March 2013 to inform our decisions about the cost of debt;
- added a table on **pensions** and have included this separately within the totex tables – to cover items such as pension deficit costs;
- added tables for **totex reconciliation**, so that companies can show the reasons why projected totex may change over time.

Alongside the tables, we also provide **definitions** that reflect consultation responses, and queries sent to Ofwat via the business.plantables@ofwat.gsi.gov.uk address.

We set out final data tables in appendices 5a to 5d. We have also updated the supporting guidance on completing the data tables (appendix 5).

12.3 Board assurance

As we explained in chapter 3, companies' Boards should own and be responsible for their business plans – and we expect companies' Boards to:

- sign off business plans;
- put in place any processes that they feel they need to be assured that they are submitting high-quality plans (in line with the characteristics set out in section 3.3 above); and
- give us a statement, in their own words, of why they consider that all the elements (and supporting data) add up to a business plan that is high quality.

In line with this approach, it is for companies' Boards to determine the appropriate internal processes and assurance needed for their business plans – including the supporting data tables. We are not prescribing (or providing guidance on) the appropriate approach to (or level of) business plan assurance.

13. Other matters

This document marks the end of our engagement and consultation on our policy and approach to setting price controls for 2015-20. We are now moving into the delivery phase of the price review – where companies will submit their business plans, and we will assess companies' proposals and set price controls.

13.1 Impact assessment

Now we are at the end of the main policy development phase, we have updated our future price limits draft impact assessment, which was first published alongside our future price limits statement of principles. This updated impact assessment has been prepared by PwC and shows that the earlier expectations of substantial new benefits from our new price controls approach remain supported by our more detailed proposals – which are additional to the impacts expected by the Government from the measures in the Water Bill.

Table 20 summarises the expected impacts from the new approaches in our methodology, based on our updated impact assessment. In this table, the scale of the expected impact is represented by a scale of 0 to 4 where: Highly material = 4, Immaterial = 0.

The impact assessment assesses the net impacts of the changes we are making in our methodology compared to the counterfactual (in which the 2009 price review methodology remains in place and Defra implements the proposed changes in the Water Bill).

It is therefore not intended as an assessment of all the impacts we expect to arise from the PR14, since we are not changing a number of important parts of the price review process - for example, our general approach to setting the cost of capital.

However from the perspective of customers, PR14 could deliver benefits above and beyond those articulated in the impact assessment. This is because inputs into the methodology, such as the cost of capital could be different at PR14 in comparison to PR09. For example analysts, such as Credit Suisse and Deutsche Bank, have noted that the cost of capital may be expected to be significantly lower at PR14 in comparison to PR09.

Table 20 Summary of impact assessment – key net impacts from the new elements in PR14

New approaches in our methodology	Summary of impact	Expected size of net impact
Proportionate regulation – **Business planning**	Our new approach to business planning is expected to **improve the quality of business plans**, ensure plans **focus on what consumers most value** (including, for example, local environmental concerns), rather than the regulator's targets, and promote culture change – towards companies **taking greater ownership** of plans, **innovating and focusing on consumers** – that could yield substantial benefits over time – by reducing our prescription of business plans, targeting our scrutiny via a risk-based assessment of plans' quality, requiring effective engagement with local consumers (challenged by CCGs which also including environmental stakeholders) and providing strong incentives for high-quality plans.	Positive – **3**
Focusing on delivery – **Outcomes approach (including delivery incentives)**	Our new outcomes-based approach will give companies flexibility to **deliver outcomes at lowest cost** and to **focus resources on what local consumers most value** – by asking companies to propose key outcome commitments rather than detailing hundreds of outputs. Our approach will also **incentivise delivery of outcomes** and enable companies to **manage risks** – by asking companies to propose their own delivery incentives.	Positive – **3**
Targeting controls – **Wholesale form of control**	Setting a separate price control for a company's wholesale activities is expected to drive improved value for money and **support future market development**	Positive – **2**

	– by improving transparency of services, costs, revenues and performance between different parts of a company's business, and enabling better targeting of regulatory incentives. Separating controls has supported efficient outcomes in the electricity sector.	
Securing value for money – **totex cost assessment and recovery**	Our new approach to assessing companies' costs on a totex basis **removes any undesirable incentives for companies to seek capital heavy expenditure solutions** where there may be better value and potentially more environmentally sustainable alternatives – by removing differences in the incentives applied to capital and operational expenditure.	Positive – **3**
Securing value for money – **menu-based cost performance incentives**	Asking companies to choose from a menu of options for their allowed costs and their share in efficiency performance will enable companies to **better manage their risk** and **incentivise lower costs** - by allowing companies flexibility to determine their level of risk and reward, and by providing incentives for companies to reveal accurate cost forecasts.	Positive – **3**
Targeting controls/Securing value for money – **household retail controls**	Setting a separate household retail price control will **drive improved efficiency, especially in the least efficient companies** – by improving transparency of services, costs, revenues and performance and by basing the control on the sector's average costs. Modelling has quantified substantial expected net benefits.	+£1,190 million – **3**
Targeting controls Securing value for money – **non-household retail controls in England**	Setting a separate non-household retail price control in England will **drive improved efficiency, support the development of the competitive retail market** proposed in the Water Bill and **protect customers** with a high cost to serve or high switching costs	+£170-360 million – **2**

	– by improving transparency of services, costs, revenues and performance, by helping to ensure a level playing field in the market and by capping the default tariffs that companies must make available to all customers. Modelling has quantified substantial expected from supporting development of the market.	
Targeting controls/Securing value for money – **non-household retail controls in Wales**	Setting a separate non-household retail price control in Wales (where customers will continue not to have choice) will **drive improved efficiency** – by improving transparency of services, costs, revenues and performance and by targeting an efficiency challenge on non-household retail costs.	Positive – **1**
Using resources better – **water trading incentive**	Financial incentives for trading of water across company boundaries will **reduce the cost of water supply** and **improve resilience of water supply** – by helping to overcome barriers to new interconnection, trading and movement of water between areas where these represent best value for money. Modelling has quantified substantial expected net benefits.	+£160-640 million – **2**
Using resources better – **abstraction incentive mechanism**	Publishing comparisons of how companies have performed in reducing over-abstraction will help **reduce damage at environmentally-sensitive sites** – by the strong incentive that may arise from putting companies' reputations at stake. This is expected to be net beneficial, taking into account the financial costs of using alternative sources, and potentially substantially net beneficial in relation to the environment in local areas.	Positive – **1-2**

Balancing risks and rewards – **managing risk**	The package of risk management tools in the PR14, including monitoring of companies' financial structures, allows us to secure the benefits of the new price review approaches with **no overall increase in risk**	Positive – **1**
Revealing information – **network plus**	Setting new non-binding price limits on the core monopoly network and treatment assets will **support future market development** and enable us to **improve regulation in future** – by revealing data on services and revenues that may bring forward achievement of the significant benefits that the Government expects from the market reforms in the Water Bill.	Positive – **2**
Revealing information – **network management**	Asking companies to report new information on their network management processes will help **improve efficient operation of networks** – by allowing Ofwat in future to set incentives for efficient network operation, similar to incentives which have delivered significant cost savings in the energy sector.	Positive – **2**

13.2 Timetable for delivery

We explained in both the methodology and business planning consultations that the timetable for delivering the price review is tightly constrained, and that we were actively exploring options to address those timetabling constraints.

We have already confirmed in 'IN13/06: 2014 price review timetable – deadline for business plan submission' that companies will need to submit business plans on **2 December 2013** – and that CCGs' reports should be submitted on the same date.

At workshops between March and May 2013, we discussed options for resolving constraints on the price review timetable. We have decided that one of these options, allowing room in the process to **defer publishing final determinations to January 2015 if required**, would introduce sufficient contingency time into the timetable to ensure a successful process for companies and other stakeholders. While it is possible that final determinations may be published earlier, particularly for enhanced companies, companies should plan on the basis that final determinations may not be published until January 2015.

As the price review moves to its delivery phase, we will soon be in a position to give more information about the detailed timetable. We have listened to, and carefully considered, company views on the timetable. It is important that companies appreciate that the detailed timetable may change. And the timetable will vary by category – companies will not know which version of the timetable applies to them until they know the results of the risk-based review in 2014. We will publish more information about the timetable for the review in the autumn.

13.3 Setting controls for small companies

In the business planning consultation, we explained that, as well as the 18 largest water and sewerage and water only companies, there are six 'small companies' – Cholderton & District Water and the five 'new appointees' – that provide water and (or) sewerage services to a small number of customers.

Because these companies are very much smaller than the 18 largest companies, we have historically taken different approaches to setting their price controls. We also explained that – in line with our future price limits principle of 'proportionate price setting' – we proposed to continue to take account of their significantly smaller size, and would take a different approach to setting price controls and business planning for the small companies. In particular, we proposed that we should:

- not set separate wholesale and retail price controls for small companies at this time;
- consider developing a small company service incentive;
- continue to set relative price controls for new appointees; and
- continue setting a simplified control for Cholderton & District Water, using a process that includes a simpler business plan and different risk-based review.

The majority of respondents agreed with our proposed approach – although a small number of companies and new appointees thought we should set separate controls for small companies which serve non-household customers. There were also mixed views on the development of a small company service incentive – and both the new appointees that responded argued that it was too early in the evolution of the market to consider a service incentive.

Some new appointees also expressed a preference for a simplified price control (similar to that used for Cholderton & District Water, rather than a relative price control).

Having considered responses carefully, we are satisfied that respondents have not raised issues that cause us to change our view. We are therefore confirming the approach we set out in the business planning consultation, and will:

- not set separate wholesale and retail controls for small companies;
- set a simplified control for Cholderton & District Water, using a simplified process that includes a simpler business plan and different risk-based review;
- continue to set relative price controls for new appointees-where the end prices they charge to their customers must continue to be 'no worse off' than the default tariffs companies offer the local incumbent companies offer their non-household customers or the household tariffs they offer; and
- consider whether to develop a small company service incentive.

We will consult separately on the detailed form of a service incentive for New Appointees outside the price review process because such an incentive does not need to be introduced in 2015 and we will engage directly with Cholderton & District Water on a simplified approach to setting prices for the 2015-20 period.

We note that obligations not to show undue preference or discrimination are already included in all of the small companies' licence conditions and so the absence of separate price controls should not cause undue concern for the operation of the non-household market.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We are responsible for making sure that the water and sewerage sectors in England and Wales provide customers with a good quality and efficient service at a fair price.

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Photograph © Stockvault
Printed on 75% minimum de-inked post-consumer waste paper
July 2013

ISBN 978-1-908116-42-0

Any enquiries regarding this publication should be sent to us at mailbox@ofwat.gsi.gov.uk.

This document is also available from our website at www.ofwat.gov.uk.

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