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23 May 2013

Dear Stephen,

Setting price controls for 2015-2020 – business planning expectations

Thank you for the opportunity to respond to the consultation on the business planning expectations for setting price controls for 2015-2020.

We have given some thought to the detailed questions posed in the consultation and set out our responses in an Appendix to this letter. It was very useful to have received a response from Ofwat to some of our detailed questions in advance of replying to the consultation, although we note that there are some outstanding questions which are understandably dependant on the final methodology statement.

Turning to the key aspects of the consultation, there is much in the business planning expectations that we support, in particular:

- the adoption of the risk based review focusing on outcomes, costs, risk and reward, affordability and financeability
- company owned business plan assurance
- recognition of the role of the Customer Challenge Groups (CCGs) as a key part of the review.

Timetable

We understand the need to seek plan submissions earlier than suggested in the PR14 methodology consultation and we would support the confirmation of a 2 December 2013 date as soon as possible as we are already planning assurance processes and CCG / company Board dates to meet this deadline. We think the submission timetable can now be confirmed as articulated in the consultation and subsequently discussed at the Ofwat workshops.

We believe it is important to have a process that enables appropriate focus for customer billing post price determination and would welcome the consideration of a November 2014 Final Determination to allow time for a careful translation into customer charges.

Business plan assessment

We agree with the high quality plan criteria that Ofwat set out in the consultation. In our view, the criteria relating to plans that are *“not a ‘bid’ and does not seek to game the regulatory process”* and “*contains fair proposals to share ‘pain and gain’ with customers”* can be summarised as “A high-quality plan should present balanced proposals that consider risk, reward and uncertainty”, somethinmg that South West Water are keen to deliver.

The consultation rightly set out a number of options for risk based incentives to produce a high quality plan. We would welcome an approach that incentivises a company to target achieving an enhanced rather than avoiding a resubmission categorisation.

We have considered the options outlined in the consultation, and believe that an amendment to the approach which retains the potential for all three categorisations, but allocates categories to each plan element, would be worthwhile. This removes, what could be considered to be, a very penal situation where a company achieves an enhanced plan across three plan elements, with one element as resubmission, but is assessed as an overall resubmission with accompanying penalties.

We believe assessments at the plan element level means that there is a greater incentive on all companies to strive for high quality areas rather than potentially focusing on avoiding the lowest categorisation.

Assurance

We welcome Ofwat’s focus on Board leadership and governance of plan preparation and assurance. This approach is consistent with our current annual reporting processes. This will allow the Board to clearly communicate and justify the plan that is being proposed, whilst referring to the additional information and analysis that has supported their decisions on the plan.

We were pleased that Ofwat confirmed at the industry workshop that data definitions for table lines would be provided and would publish “questions and answers” concerning the tables and line definitions as they arose. We have a number of clarification questions in this area.

The consultation made it clear (and this was confirmed at the industry workshop on 7 May) that the Ofwat Board had yet to reach a conclusion on the final PR14 methodology following the consultation response points made by companies at the end of March. Changes to the business plan tables may be required as a result. We would welcome the opportunity to continue the constructive engagement we have had in exploring how the tables may need to adapt, a process which has allowed us to highlight some key points in response to the detailed questions in the consultation in an Appendix to this letter.

Please contact me if you would like to discuss any aspects of our response in more detail.

Yours sincerely,

Susan Davy
Finance & Regulatory Director

APPENDIX – DETAILED CONSULTATION RESPONSE

<u>An incentives-based price review process</u>

Q1 *Do you agree with our definition of a high-quality business plan? Is anything missing? Is there anything you think we should change?*

We agree that high-quality business plans are those that are designed to deliver good outcomes for customers and the environment both in the long and short term, and ensure that companies meet their statutory obligations. Companies should forecast the cost of meeting these commitments as accurately as possible.

We would add to the criteria that the plan should be based on effective engagement with customers and stakeholders. Ofwat has consistently set this out as a fundamental part of the PR14 process and it is something that SWW is fully committed to in all of our plan preparations.

It is important that companies are clear where there are uncertainties that may affect the outcomes or costs and how they have taken this into account in preparing their plan. A high-quality plan should present balanced proposals that consider risk, reward and uncertainty. We would suggest that the high quality plan criteria relating to plans *"not a 'bid' and does not seek to game the regulatory process"* and "*contains fair proposals to share 'pain and gain' with customers"* can be summarised by this single point.

The approach and process presented for this price review is different compared to previous reviews. There is a move to an ex post rather than an ex ante assessment of company plans. Key areas of information relevant to the business plan (such as cost assessment) will not be available until later in the process – after company business plan submission. In this context, it is important that high-quality plans explain how such uncertainty affects the balance of risk and reward.

Q2 *Do you agree that our preferred package of reputational, procedural and financial incentives will incentivise high-quality business plans? If not, what do you think we should add to the package, or change?*

We agree that where companies deliver high quality plans then there should be procedural and financial incentives, with reputational benefits also deriving from this. High quality plan elements and overall high quality plans should be substantially accepted as a whole, which will provide certainty to the company and customers. Once companies are categorised as having a high quality plan, there will be benefits from having an earlier draft determination so that the company can confirm that they are content that this is consistent with their plan.

The hurdle for achieving an enhanced rating is noted as being high, and it appears that Ofwat expect only a few companies will obtain an enhanced ranking. It is important that communication on this assessment explains why this is the case and is appropriate, given the nature of the duties imposed on Ofwat to balance consumer interests with securing that efficient companies can finance their functions. The role of Customer Challenge Group (CCG) should take centre stage in the Ofwat assessment, with specific reference to the weighting that has been placed on local engagement and opinion in forming its conclusions on the quality of the plan.

It is important that procedural, reputational and financial incentives are balanced where Ofwat do not allocate plans to the enhanced process. In terms of the procedure, it is important that plan elements that are high quality are recognised and treated accordingly in terms of the reputational and financial incentives. Companies that produce high quality plans in all except one element, for instance should Ofwat initially disagree with the assumptions made, should have this recognised. This will help to ensure that companies aim for high quality, rather than focusing on sufficiency to deliver standard and avoid resubmission.

This will also help to ensure that plans are initially scrutinised “in the round”. There is a risk that industry level cost assessment will dominate the process and plan rankings. Whilst accepting that Ofwat do not wish to publish assessment models prior to plan submission, companies will need an opportunity to consider the implications of this new information for their own plan once these are published. For instance, apparent cost assessment differences in one area should not prevent a high quality plan remaining considered as such before the company has considered the implications.

It is not clear what happens in the process if Ofwat’s assessment is a re-submission category and there is a difference of opinion with the company and the CCG. We need to consider what happens if the company disagrees that re-submission is required, perhaps due to further information expected later in the process.

There is a difference between a regulator taking judgements that differ from a company plan and reflecting this in price control determinations, and requiring a company to resubmit. Again, this is another reason why assessment at the overall business level is difficult (and why resubmission would need to emerge through the process at a plan element level).

Q3 *Which of the options (elements earn procedural and financial rewards; two-category approach; two-process approach for retail; later decisions on resubmissions) do you think we should use, if any? Why?*

We had considered the options for a two category approach of a standard and enhanced ranking across all of the price control elements. This may be appropriate for the initial assessment undertaken by Ofwat, where it is not clear initially whether resubmission is required until dialogue with the company/CCGs has taken place. However, depending on the process for Ofwat scrutiny even of standard plans, the potential for a resubmission category being required will remain. An initial assessment of categorisation at the plan element level will support this process.

The assessment and incentives should be at a plan element level, but ultimately these categorisations should consider the materiality to the overall plan. The initial ranking of plans can be at plan element level across all three categories. A re-submission option is more likely to be required for wholesale than retail given the difference in complexity and number of assumptions involved in producing a plan, but with a plan element level process and incentives this distinction does not need to be made.

We therefore believe that Ofwat should start within an initial categorisation of plan elements, with final decisions on any resubmission to be agreed with the company once draft baselines have been established so that the materiality of challenge to the whole plan can be fully identified. The impact of resubmission to the remainder of the price review timetable and to the menu incentives can then be discussed, as it will depend on the scale and nature of the issue. Although this is less likely to be required for retail, this approach provides some flexibility for this eventuality.

The same procedural incentive is maintained through this approach as with a three category ranking of the whole plan rather than plan elements. The reputational incentive of the enhanced category is improved with the focus on the plan elements in the first instance. Further detailed scrutiny of the standard category elements will then determine the process and incentives – companies would have ownership of the decision to resubmit in advance of the Ofwat timetable where further information was required in order for a menu approach to be retained. Ofwat can then identify the menu process they believe appropriate for each company and the incentive rates. Specific financial rewards can be set out for enhanced companies and plan elements, but no specific financial difference should be made between standard elements and resubmission elements other than through draft and final determination judgements that Ofwat make (which at draft determination includes what the available menu). The menu option can reflect whether the company resubmitted relevant data as part of the Ofwat menu and price control decisions. This keeps a clear distinction between regulator decisions and company menu choices about its plan.

***Q4** Do you think that our proposals will be effective in meeting our objective of handing back ownership of the business plans to company Boards?*

The developments in risk based regulation in recent years have focussed on Board ownership of the process by which the company demonstrates that it is delivering for customers and how it meets its obligations. We agree that this approach must equally apply to the price review process and submission of business plans.

We support the focus on using the Financial Reporting Council's 'UK Corporate Governance Code' as guidance as to how Board's should approach plan assurance and ensure there is transparency in how it operates and leads the company.

We agree that it is appropriate for the whole Board to provide an assurance statement on the high quality of the company plan. This approach to sign off and assurance has been used for SWW submissions in recent years, both for annual reporting and for charges submissions, reflecting the public trust and legitimacy importance involved in publishing performance information and arriving at customer charges. We are enhancing our existing approach by separately identifying SWW's compliance with the UK Corporate Governance Code at the company as well as the Group level.

There is one aspect of the business planning expectations and timetable where we feel could be clarified. It would be useful to understand how Ofwat would like to engage with dialogue about the company plans in order to allow Board's to provide leadership to the process. Discussions with the industry about plan methodologies and processes inevitably have to consider detailed working level issues and technical practicalities (such as what information should be collected and in what format). We believe it would be worthwhile to include Board level dialogue with Ofwat in the price review timetable, helping to ensure clarity within the business plans and that expectations are met (avoiding surprises given the significant changes to the price review approach to that taken previously). We suggest that there should be three main phases of Board level dialogue - in advance of submission (October 2013), before plan ranking based on initial assessment (February 2014) and to support the decision making phase (Summer 2014).

<u>The risk-based review in detail</u>

***Q5** Do you agree with the four high-level groups of tests (outcomes, costs, risk and reward, affordability and financeability) are the right ones? If not, what do you think we should add or remove?*

We agree with the four high-level groups of tests are the right ones for Ofwat to consider. In effect there is a fifth test set out in the consultation that considers companies performance in 2010-2015, which we think is also relevant in terms of both the track record of delivery (the Board's track record of leadership in meeting obligations) as well as the specific incentive and financial adjustments built into the existing regulatory framework.

On outcomes, we agree that the focus should be on what the company is proposing to deliver for customers, stakeholders and the environment. The proposed business plan tables put a significant degree of focus on how costs are allocated to the different outcomes. We would be concerned if the focus was on an accounting allocation exercise rather than the outcomes and deliverables, so we agree with the focus of this risk review criteria.

On costs, whilst we agree with the high-level purpose of reviewing the cost associated with delivering outcomes, Ofwat will need to consider how to link the industry-level cost assessment processes used in the risk based review to challenging the company-specific outcomes. Cost assessment and models generally focus on activities and outputs rather than outcomes, because these are more readily measured at an industry level.

We think that how the company balances risk and rewards between customers, the company and investors is the most important risk-based review criteria. The business plan tables propose collecting a number of areas of information, including on different scenarios, in order to support this process. We think the focus should be on the company generated scenarios because the focus of the risk based review is on how the company has balanced risk and reward

At a high level we agree that it is important that risk based review considers both the impact of the company's proposals on customers' bills (affordability), and its ability to finance its functions (financeability). However, affordability as a concept goes wider than just considering issues that are directly considered by the price review process. There may be factors outside of immediate industry control (e.g. rising energy bills, and policy obligations that are placed on the sector) which affect affordability directly. There are risks associated with a water sector has a stronger criteria of affordability placed on it than that applied to other sectors. We would therefore suggest that the risk based criteria should consider the acceptability and financeability of the plan. Affordability is rightly part of the overall acceptability of a plan service and bill package of proposals. This reflects that company proposals should consider measures to support those who have wider affordability issues as part of a plan that is as acceptable as possible to customers and stakeholders. The focus on acceptability would also be consistent with the plan engagement challenges that Ofwat set out in the *Future Price Limits* principles.

One particular comment we would make is that we do not think that the tests can be considered sequentially or in isolation of each other – Ofwat will have to be consider the approach taken by a company in the round. This is particularly important with the the separate price controls, as a company plan may have accepted challenges in one price control that are balanced by opportunities elsewhere, for instance between cost challenges and overall financeability.

Q6 *Do you think we have set out the right tests in each group? If not, what do you think we should add or remove?*

Outcomes

As well as the tests used within each group, Ofwat should recognise the importance that the CCG report is considered for the overall balance of the plan as well as for outcomes. For instance, acceptability of the plan covers both the outcome commitments plus the overall balance of risk and reward that a company is proposing. We believe that a CCG will consider these wider factors as part of the evidence it requires for reporting on engagement, performance commitments and outcome incentives to support Ofwat's tests.

We agree it is not practical for Ofwat to publish specific criteria or "pass marks" for the risk-based review tests at this stage. We would urge Ofwat to place greater weight on what the outcomes deliver for customers (particularly where it is supported by customer engagement and the CCG following their scrutiny of the process) rather than whether the technical delivery of incentives matches a framework methodology. This would recognise that it is important that the company plan is customer rather than regulatory process focussed. We agree with Ofwat that a high quality "enhanced" company plan can still expect some changes to be considered before determinations, and the precise delivery incentives may be such an area where mutually beneficial improvements can be identified once Ofwat has carried out an initial review of plans.

Costs

For cost assessment, the criteria that Ofwat set out will need to be more specific than set out in the consultation. Cost corridors and cost ceilings are suggested in the consultation, but whether these are applied at an industry level or company level will also depend on the materiality of the impact on the overall plan. As we set out in the previous price review consultations, there has been insufficient information published about the wholesale cost assessment approach to know whether company costs would be consistent with the cost assessment outputs, and what information might help to explain this.

Therefore we would suggest that the risk based assurance criteria for wholesale costs should simply consider whether the company has sufficiently explained its drivers of cost to allow it to be compared to the cost assessment results. This recognises that Ofwat will need to scrutinise whether company costs have been atypically low in terms of past investment (or have been submitted low as a forecast as part of a "bid") as well as scrutinising cost submissions that are higher than would have been expected.

The criteria for the household retail cost to serve appears logical, although this will depend on the final methodology approach. A criteria as to how the average cost to serve has been allocated between water and sewerage customers may also be required.

For retail costs, the response to the questions we submitted in advance of replying to this consultation suggests there remains significant uncertainty as to what approach company's should take in proposing non-household retail tariffs in the business plan submission. Therefore this does not allow us to judge how the assessment criteria on recovery of costs and margin and unduly discriminating between customers could apply in practice. These proposed criteria would relate more to market price retail tariffs rather than a default maximum price for the minimum level of service that is also suggested in the PR14 methodology consultation. The criteria for the default tariff approach would be very different, for instance considering whether the company had specified a default level of service and demonstrated how this cost differed from the general level of non-household retail services.

Risk and reward

There will be a significant amount of judgement involved in the risk-based review tests for risk and reward that Ofwat set out in the consultation. For instance, what is sufficient information is not easy to establish given that this is a new aspect of the regulatory approach. Similarly, Ofwat will need to define what "plausible and acceptable" risk ranges are, which will be difficult to do until receiving risk information from company plans. How are we to judge what an "efficient level and allocation of risk" might be in commitments and incentives?

Our experience with risk modelling at previous price reviews and for our own business planning processes is that focussing on a small number of key relevant risks and metrics is important. We would therefore suggest that the risk criteria could be simplified to focus on how the company has demonstrated that its chosen plan had balanced risk and reward, and whether it has demonstrated that this plan balance is consistent with the views of customers, stakeholders and the CCG. The focus should be on the company scenarios used to test this risk rather than the general scenarios.

Affordability and financeability

As discussed above, we think it is important that the risk-based review criteria tests consider acceptability rather than affordability. This will allow the bill impact mitigation (such as social tariffs) and company specific bill drivers to be placed in the context of customer Willingness to Pay for service improvements and the degree to which there are legislative drivers of cost that Government policy supports. This focus will allow the assessment criteria to consider whether companies have tested the acceptability of their proposals in terms of the available options for bill levels and service levels.

We agree with the overall financeability criteria that Ofwat set out. We are less clear at this stage about how the financeability of the individual price controls can be assessed in practice – particularly over the longer term given the uncertainty associated with the future direction of market reform that will affect these individual controls.

The financeability test should also consider past investment programmes and capital structure decisions and how company policies affect their view on risk. Ofwat will need to judge what a fair balance between company, current and future customers is, and the degree to which past investment and company financing decisions affect what is fair. We think fairness continues to be best represented through setting an overall industry cost of capital, with financeability continuing to be assessed against this framework. A move away from this approach would require much greater judgements and complexity in how financeability was considered.

Performance in 2015-20

In general we agree with the criteria, although it is important to recognise that there are a number of questions associated with the AMP5 CIS framework where there is uncertainty within the current guidance, which states that this will be considered in the PR14 financial model (in particular how to re-price the financing adjustment from base year prices).

With SIM, Ofwat have not published a performance rewards and penalties calculation framework, so even if companies can calculate their relative performance to other companies, it is not clear whether/how this should be applied compared to their own performance progress. SIM leaves this to regulatory judgement as part of the price review process. Ofwat should make it clear if there is a specific approach which companies are expected to use to calculate SIM financial adjustments.

Q7 *Do you think our proposals for business plan assurance will be effective in meeting our objective of handing back ownership of business plans to company Boards?*

As outlined under Q4. above, we support the approach to Boards taking ownership of both plan development and assurance. We agree that Ofwat should not prescribe how Board's obtain assurance, instead setting out the high level principles of the corporate governance that Ofwat expect companies to adhere to.
We also welcome the approach to the business plan narrative – this is consistent with the Board ownership of the plan development and assurance. The distinction between specific data definitions of business plan table requirements and how the overall plan is presented in the business plan narrative provides the right balance between submission of consistent data and the risk-based review approach set out in the business plan requirements consultation.

Delivery focussed information requirements

Q8 *Our objective in specifying the data tables (and the August submission) is to ask for all of the information we need, but no more than we need. Do you think that we have achieved this? Is there any information that you think we might not need? Is there any information that you think we will need but we have not included in the data tables?*

Generally we think that the balance of information in the August submission is about right. We would urge Ofwat to clarify the requirements, data definitions and the submission date as soon as possible.

The capital expenditure purpose tables have a number of standard lines which may or may not be relevant to each company. We agree with the approach taken for the company to submit other lines that reflect its own approach to analysing investment drivers.

The remainder of the data in the August submission is focussed mainly on cost assessment, and without details of the cost assessment models it is not possible for us to know whether the information will be needed or not. As we set out in our PR14 methodology consultation response, our work does not indicate that totex models are likely to be any more or less robust for wastewater than clean water. If wastewater totex models could be used then there would be no need to collect the large sewage treatment works data. However, given the uncertainty associated with the cost models we agree that the data should be collected.

We have a specific question on table 4 (explanatory variables – waste water),lines 41 to 51. Thes are new lines (therefore no definitions are currently available) that request current population equivalent served by various schemes/treatment works. The purpose of these lines wasn't clear to us. For instance for those that refer to a driver or tightened/new consent, whether this should report only the impact of schemes implemented in a particular year or a cumulative amount, and if a cumulative amount from what date (AMP5?, since privatisation?). Lines 43 and 45 also refer to drinking water and groundwater protection schemes which we were unsure of the definition for. Data requested is only requested for 2010/11, 2012/13 and 2014/15 so it may be a cumulative total in AMP5, but this isn't specified. In general, the tables should specify whether annual or cumulative data is required. Line 31 and lines 56 appear to be duplicated – number of connections to the sewerage system.

Table 4, lines 1 and 2, could potentially better refer to non-duty and duty properties served by s.101A schemes respectively.

One additional point of clarity, on table 5 for private sewers, it may be better to refer to the "pre transfer" rather than "current" network in order to be clear about the distinction (as in 2012-13 the pre transfer network became current).

Q9 *We aim to collect data on a consistent basis from all companies. Are the data tables clear and well specified? Are there any areas where we need to look again at the way we have asked for the data to remove any ambiguities in the request?*

We provided comments on the data tables in advance of responding to the consultation and have used Ofwat's response to inform our conclusions below. This process was very helpful to us and we would support Ofwat maintaining an overall summary of questions asked on the data tables and the responses, either on the website or circulated regularly via email.

One overall comment is that all lines, whether new or existing, will need detailed data definitions to be provided to ensure that consistent data is submitted in order to support the Ofwat review process.

We have grouped our detailed comments in response to this question into the key plan section topics of:

- Outcomes and costs
- Financial information
- Price controls / Tariffs
- Scenarios & risk

This approach is consistent with the risk based review criteria proposed by Ofwat and recognises that outcomes and cost projections need to be considered together.

Outcomes and costs

One area where we require greater clarity is whether all cost projections be included on the Outcomes expenditure total table, or should this just be totex expenditure (ie excluding costs included on the excluded variables table?) For costs that may be better not considered through totex (e.g. those company specific costs such as EA charges and business rates that vary between company not directly due to company performance), we see a similar logic in not allocating the costs to the outcomes framework.

Although Ofwat intend to use the 2012/13 MEAV valuation to support PR14, we believe there is a logic in being able to update the valuation if companies choose to do so to support their future financing and RCV run off ratios. We think that Ofwat should allow companies the flexibility to propose a new valuation bases as at 01.04.13 as part of the price review.

Where current performance and customer expectations go beyond the economic level, and no changes are proposed, Ofwat have confirmed that this should fall within the “totex to maintain 2014-15 performance” category. We are not convinced of the value of allocating all existing cost to the outcomes framework. In practice, there is a base level of cost that will support a wide number of outcomes (mostly delivering a number of existing performance levels), and a new cost allocation exercise in additional to accounting separation will be required just for the purposes of populating these tables. We think the outcome tables could be simplified to collect data on the marginal cost and benefit incentive proposals, which will reflect the customer impact focus that the outcomes approach is designed to achieve.

In order to understand whether the cost and outcome tables will be provide suitable information, Ofwat guidance needs to clarify whether the cost corridors / cost ceilings explanation required in the plan is required at the total service totex level, or a mixture of outcome level tests and total service tests (ie the outcomes represent where future costs are higher because of activities / service levels being delivered, with the base performance totex representing efficiencies and base cost changes (e.g. power prices)? Understanding this helps to ensure the plan narrative exposes any assumptions / risks.

Further guidance is required to clarify the “portfolio score” for trade offs (e.g. table W2). How should outcomes without measureable performance level metrics be included (e.g. if they have a fixed delivery date for instance?)

Table W3 – Ofwat clarified that companies should split capex between maintenance and enhancements for a particular driver, where the company considers the proportion of maintenance spend relative to that element of the programme, is significant. In such cases, an appropriate level of explanatory commentary is expected. However the approach to opex cost for this table to be consistent with the totex approach remains to be clarified.

Table W4 – A forecast of serviceability out to 2020 is required, despite this concept not existing in the PR14 methodology as it has been subsumed within outcomes framework. Ofwat helpfully clarified that this was based on the AMP5 definition and reference levels. The PR14 methodology allows companies to determine their own outcomes and Ofwat do not require companies to include serviceability in this form in either your outcomes or measures of success in the business plan. In our PR14 methodology consultation we questioned whether serviceability was a valid cost assessment variable given that it was based on company specific performance levels.

Table A4 – Ofwat confirmed that there will be more information on the scope of network management and network plus so companies can calculate what the costs of obtaining it may be. At this stage we are still concerned as to whether there will be sufficient clarity in order to establish the cost of these requirements for PR14.

Financial information

We questioned whether all the financial A tables were on a full IFRS basis (e.g. with bad debt adjustment to turnover and operating expenditure). Ofwat suggested that companies should take whichever approach they intend to take for your 2015-16 accounts, so either IFRS, FRS101 or

FRS102. We support Ofwat's use of IFRS, although the flexibility that Ofwat describe may mean that it may be difficult to compare different company submissions on a consistent basis using these tables.

We also have questioned where data on the company CCA accounts projection would be required to tie into the rate of return / financial ratio calculations (and because of the RCV run off / PAYG ratio assumptions). Ofwat suggested that there was no need for CCA accounts as financial returns will simply look at a 'revenue requirement' type P&L, which will not be the same as the accounting P&L. However, this means that there is no location in the business plan tables where companies are submitting how the PAYG and RCV run off ratio components (together with tax and rate of return on RCV) built up into the overall revenue in the 'revenue requirement' type P&L. We do not understand how Ofwat will be able to scrutinise this information based on the plan tables unless a financial model is also to be provided to capture this data and calculations in advance of company plan submission, something not mentioned specifically in the methodology consultation or this business planning requirements consultation.

We are not sure that table A17 for "off balance sheet debt" is required, or what type of financial information would be categorised this way.

We think the following points will need to be clarified further. Our discussions with Ofwat have confirmed that this would be considered in the final guidance, although we would welcome any update available ahead of this:

- Table W18/S18 – Which cost of capital is the company proposing based on this information (notional or company gearing), and how do companies make this clear (in the plan narrative?). Is this a view as to what future cost of debt is needed (e.g. forecast for embedded debt in the future), that takes into the risk allocation and balance proposed.
- Table W19/S19 – Issues to be considered include: what assumptions are being made in the actual return to equity? Does this assume that performance rewards in the actual return on RCV accrue to equity returns (i.e. the company pays these out in dividends?), or is this up to the company? It would be useful to debate the different cost of capital and equity return between water and wastewater within wholesale, and how to consider this with financing of the whole regulated business (e.g. debt and equity is not split between the two, and neither is gearing even though the RCV and investment needs may be very different). Financial ratios are only considered in the 'A' tables as a whole rather than split between notional and company gearing and wholesale service level.
- Table A2: does not show closing net debt (ie only shows opening gearing), but not necessarily distinguished between actual company and notional balance sheet to be consistent with gearing in cost of capital?

Table A2 is headed as "Wholesale Financing". Ofwat confirmed that this table relates to the appointee as a whole so would include any dividend and interest within the retail component (e.g. from the margin).

Price controls, Tariffs & Retail Margins

We have a number of questions surrounding retail costs and margins in particular, and the translation of revenue controls into price limits overall. Ofwat confirmed that these questions would be clarified in the final guidance:

- For retail costs – will the average cost to serve include capex/depreciation allowances, or is this included in the margin allowance? The tables imply just operating expenditure in the Average Cost to Serve, but the margin is just for working capital?
- Should the non-household retail margin be calculated on a stand alone basis, or should it reflect regulated cost recovery and returns, as a default tariff that is the maximum price for a standard level of service? Should companies set out in this the assumptions they

are making on the default tariff level of service? Will any market reform assumptions be available for companies to consider appropriate margins?

- A discussion on the balance between affordability with acceptability – proposals for services and prices may be broadly acceptable across the customer base, but “affordable” is a sum of a separate issue for a set of individual customers (not just water industry cost factors concerned)? Clarity on this will help to ensure that the plan narrative describes both of these factors when considering the risk allocation and financing issues.
- Table W8/S8 – Is this a base revenue projection, or one with proposed price changes included?
- Table A1 only asks for K factors from 2016-17. Is this to avoid having to split 2014-15 revenues into the new price controls? How should companies express what the change in wholesale tariffs is from 2014-15 into 2015-16 given this? The licence specifies determination of K factors in all years.
- Table A12: Is it the marginal or total receivables for retail (on top of wholesale) expected on this table – what payment assumptions for retailers are expected?

Ofwat clarified for Table A13 that the ‘accrual rate’ should reflect the percentage of measured turnover for the year which is accrued at the year end. We are not sure to what purpose the forecasting this data serves in the price review framework, particularly given that this data has not been collected historically within the regulatory framework.

Ofwat clarified for Table R4 that only retail elements of tariffs is needed for this table. We agree that water and sewerage for retail tariffs may be required, although this may depend on the final Ofwat methodology. The tariffs in this table may need to be on a per meter rather than a per customer basis, but Ofwat may want to consider defining the use of an average per customer basis for the purposes of the price review submission.

There are a number of methodology consultation issues relating to the wholesale revenue yield adjustment factors which will affect the W12 table and potential S12 table. The cost of a new meter optant is very different to the cost of a new metered connection. An allowance in the revenue yield for new connections is required in order to allow developer requisitioning and infrastructure charge income to vary (hence allowing new developer charging rules to be implemented following a potential Water Bill). A similar approach is likely to be required on sewerage (with no difference to the developer cost driver). However a single value for both developer costs and meter optant costs is unlikely to be appropriate.

Scenarios & Risk

The scenario modelling section is an extensive and potentially a very large area of work – particularly for the “rainfall” scenario which is trying to capture all weather impacts. We would suggest this could be simplified so that companies flex key assumptions from their point of view, or just to use company specified scenarios that are relevant to their plan rather than the standard scenarios (which could be a stage after submission as part of plan review?)

Given the scale of the scenario data requirements compared to the rest of the business plan submissions, we think collecting less data and focussing on the plan risk narrative may be a better balance in line with the principles Ofwat set out for the PR14 business planning requirements.