



**Setting price limits for 2015-20 – final methodology and expectations for companies’ business plans
Welsh Government and Natural Resources Wales briefing session: questions and answers**

Q1: Where does the cost of capital fit in? When will Ofwat make the decision on this?

- The process of assessing the cost of capital is similar to the previous approach. We will set one notional Weighted Average Cost of Capital (WACC) for all companies.
- What’s new this time is that we have said gearing should be pitched somewhere between 60% and 70% (compared to 57.5% in the previous price review), but have not set a point estimate within that range.
- We are encouraging companies to state their own view of the WACC.
- Based on the PriceWaterhouseCoopers report we commissioned, attached as an appendix to the methodology, we have said that it’s possible for companies to have a different WACC but that this would need to be supported by very strong evidence, which we are not currently seeing.
- We set out the downward trend in the underlying macroeconomic fundamentals. We noted that that the new Governor of the Bank of England had recently said that interest rates will remain low for some time, until unemployment rates fall below 7%, implying that the cost of debt will also remain low.
- We have not yet made a decision on what the WACC will be.

Q2: What was the key feedback from the briefings with the water companies? What specifically did they say about the role of Customer Challenge Groups (CCGs), affordability, and the status of the post-submission meeting with Ofwat?

- The discussions were broadly positive, with the companies welcoming the lack of surprises in the methodology. The detailed questions and answers raised in the sessions with the water-only companies and the water and sewerage companies are [available on our website](#). The following questions were built on in the Cardiff meeting.
 - The companies queried the role of the Customer Challenge Groups (CCGs) after the risk-based review (RBR), and after final determinations.
 - We have specified that we would expect a short-form CCG report on a resubmitted business plan, but that the role of CCGs for enhanced and standard business plans would be left to the companies.
 - CCGs and other stakeholders have told us they believe there is a role for the CCGs beyond the final determinations. It will be for the companies to decide whether to continue with the role of the CCGs.
 - The companies had asked how high a priority affordability was for the price review (and how high a priority it is for the UK Government and the Environment Agency).
 - Statutory requirements would clearly need to be met in the business plan.
 - If the Welsh Social and Environmental Guidance did include a specific requirement to companies on affordability, they would clearly need to fulfil this in their plans.
 - The balance of affordability with financeability was a matter for each water company, taking into account the views of its CCG.
 - We confirmed to the water companies that the meeting offered with Ofwat after business plan submission was neither mandatory nor would impact the RBR – the latter would assess the plan, not issues discussed in the meeting.

Q3: What does a wider or narrower menu mean in practice? What would an 'enhanced' menu look like?

- Under the totex menu, companies can consider a range of incentives, and enhanced companies will be able to keep a greater proportion of financial benefit if they over-perform on their incentives.
- We will need to calibrate this so it has material financial benefit (compared with a 'standard' company) but does not over-reward.
- We will also continue with the Service Incentive Mechanism (SIM), which will have its own incentives.

Q4: Without water efficiency targets, won't companies aim too low on water efficiency? Will treating water efficiency as retail (while metering sits under wholesale) act as a disincentive to companies? The Welsh Government had wanted a specific reference to, or a requirement for, water efficiency in Wales. The WRMPs weren't very encouraging on water efficiency.

- The methodology offers an opportunity for forward-thinking companies to do more on water efficiency than in the past – consistent with statements we have been making in recent years that companies will need to increase their activity in this area.
- Totex should help to address the perceived capex bias which had disincentivised water efficiency in the past. Companies are free to set an outcome on water efficiency.
- The focus on retail is intended to make companies more responsive to what their customers wanted, though we recognise that this impact will be lower in Wales, in the absence of competition for non household customers
- It will be important for other regulators to raise flags with their CCGs (and perhaps reflect this in the CCG report) if they are not happy with the level of water efficiency proposed by companies.
- The customer-facing elements of metering will fall within retail not wholesale.
- Of course water companies will need to plan to meet all statutory requirements in their business plans.

- If there is a water efficiency requirement in the SEG then companies will need to meet it.

Q5: For the next price review (PR19) it would be important to learn lessons on how well the CCGs and other aspects of PR14 have worked. The direction of travel in Wales was for greater water efficiency and metering, and this would be set in policy by PR19.

- We always carry out a 'lessons learned' review after a price review. PR14 will be no exception. There are a number of innovative elements to this price review and we would want to know which aspects worked and which did not so we can improve on this in the future.

Q6: How the companies are phrasing questions to customers (for example in willingness to pay surveys) was in some cases a matter for concern, with for example statutory commitments being presented as optional. Some questions might be considered to be 'leading'.

- If some questions were considered to be leading and this resulted in unacceptable outcomes in the business plan, we would expect this to be flagged up in the CCG report. Even if only one member of the CCG felt strongly about this, it could ensure views were covered in the CCG reports.

Q7: Wouldn't the potential receipt of 22 radically different CCG reports be problematic to assess? Would the same apply to companies' business plans? This would need to be a lesson learned.

- Given that companies were being encouraged to own their plans, in theory we would consider 22 different plans and CCG reports an encouraging move.
- The balance between challenge and capture and the time and resource commitment of CCGs were issues that had been raised for consideration after PR14.

Q8: How will WFD (Water Framework Directive) schemes which become clear after the final determination be delivered, reflecting the 'managing uncertainty' approach agreed by EA and NRW? Will there be a change protocol mechanism?

- We have not said that there will be a formal change protocol (though have not explicitly ruled this out).
- We will leave this for companies to consider, and will look at the issue again once business plans have been received.

Q9. Will the increase in licence fees be used to implement the new market? This would mean Welsh customers subsidising competition in England.

- The increase in licence fees is to finance this price review, not to deliver the new market. The funding for the Open Water programme (implementing the new market) is separate to the price review funding.
- It's usual in the regulatory cycle both within the water sector and more widely to employ consultants to manage peaks in workload.

Q10. When will the Welsh SIM consultation start?

- This will start on 14 October.

**Ofwat
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