April 2014

Setting price controls for 2015-20 – policy and information update

Correction
Table A5 on page 43 and table A6 on page 47 were corrected on 11 April 2014.

Overview

In our pre-qualification decision document ('Setting price controls for 2015-20 – pre-qualification decisions', published on 10 March 2014) we explained the outcome of our risk-based review of the companies' business plans. We said that the companies' plans were generally of a higher quality than in previous price reviews – particularly in the way that companies are engaging with customers to deliver their priorities. The customer challenge groups (CCGs), along with the regulatory incentives, have played an important role in delivering higher-quality plans.

While all companies had delivered business plans which showed a step change in focus and approach, two companies – **South West Water** and **Affinity Water** – produced high-quality business plans that stood apart from the other companies.

For other companies, the risk-based review has identified areas where further dialogue is needed to improve our understanding of their plans before we can discharge our duty to ensure that consumers' interests have been protected.

By publishing information today, we are being fully open and transparent with all stakeholders.

Today, we are publishing the detailed results of the risk based review for all companies. This information has already been shared with companies. We are making this information more widely available to all stakeholders to support effective challenge of companies' plans and to help ensure that we can generate the best possible outcome for customers.

We are also publishing further information on our policy decisions and on the requirements that companies need to take into account in the next steps of the price review. This information should help companies retain the ownership of their own plans, and to address the issues we have identified. We want to support companies in improving aspects of their plans and help them to deliver the best possible outcomes for their customers.

Companies will now need to choose whether to apply for a June or August draft determination.

In our pre-qualification decision document, we said that companies will need to consider our decisions carefully to assess what additional evidence and reasoning they need to submit to us, either by 2 May if they wish to seek a June draft determination or alternatively by 27 June if they wish to receive an August draft determination. It is for companies to decide whether they will be in a position to submit any revised tables and new evidence to sufficient quality by 2 May.

We recognise that new information will become available between the date that we set June draft determinations and when we set August draft determinations. This means there will be a number of areas of our June draft determinations where conclusions are provisional, pending the release of updated data, the outcome of parallel policy consultations, or confirmation of external circumstances.

We confirm that final determinations published on 12 December, will not be affected by whether the draft determinations were published in June or August. Our approach to setting final determinations, including any updates to reflect material changes in external circumstances, will be the same for both June and August companies.

We set out in more detail our expectations for the process for June and August draft determinations.

By 17 April, companies will need to indicate whether they intend to apply for a June draft determination or an August draft determination. Once a company has made this decision, there a number of steps they will need to take.

Companies will need to submit a ‘gap analysis’ to us, either by 17 April if they are seeking a June draft determination or by 13 June if they are seeking an August draft determination. This should indicate the areas in their business plans they have revised, or intend to revise, ahead of submitting the revised information. It should also provide details on the actions the companies plan to take to bridge the gaps identified.

This gap analysis will form a useful basis for dialogue between companies and Ofwat. It will also help companies to consider whether a submission on 2 May will be feasible. For August companies, the gap analysis will help focus their effort and better target engagement with stakeholders including CCGs.

We will continue to have a constructive and appropriate dialogue with all stakeholders through to the end of the 2014 price review, and will be offering a series of meetings and workshops to companies to support them as they revise their business plans.

It is also important that companies have an effective dialogue with their CCG so that the CCG can understand:

- what changes in the company's business plan might be material to customers;
- where it needs to focus its challenge; and
- what it wants to come back and tell us.

Companies should look to involve CCGs in a proportionate, focused way. We have asked the CCG to provide us with a short form supplementary report that addresses the key changes in the submission. The specific information that companies will need to provide to us to support their revised business plan submission depends on the nature of changes to their business plan. But we strongly encourage companies to focus on ensuring the highest quality plans – if regulatory intervention is then still required to protect customers, this will be reflected in our draft determinations.

Table 1 below summarises the areas of further information published today. For each area, this document either provides the further information in the appendices, or where the information is provided outside this document, signposts where further details can be found.

Table 1 Summary of information and its purpose

Area	Issue	Summary	For which companies is this relevant?	Further information
Risk-based review of company business plans	Risk-based review feedback	We are publishing the material that Ofwat's Board used to decide whether companies pre-qualified for enhanced status. We are also publishing our internal methodology, which describes the tests and our expectations for each risk-based review test.	All companies	Appendix 1, our website, including '2014 price review risk-based review – internal methodology'
Equivalence of treatment for June and August draft determinations	Draft determinations process	In this document, we explain our approach to dealing with new information that becomes available between 25 June and 29 August – that is, the dates at which we will publish draft determinations which are not enhanced.	Companies receiving June or August draft determinations	Appendix 2
Process for June and August draft determinations	Draft determinations process	This document explains what we expect companies to submit ahead of June and August draft determinations and how we will engage with companies affected.	Companies receiving June or August draft determinations	Appendix 3

Area	Issue	Summary	For which companies is this relevant?	Further information
Focusing on delivery	Service incentive mechanism (SIM)	We are publishing the outcome of the future SIM consultation we initiated in October 2013. We set out our conclusions on the SIM incentive properties in the pre-qualification decision document. We are also now confirming the SIM measures and the program for testing them. This includes a trial of measures for the small company service incentive.	All companies	Appendix 4 and 'Service incentive mechanism (SIM) for 2015 onwards – conclusions'
	Abstraction incentive mechanism (AIM), network plus and network management incentives.	We set out our approach to taking forward these important areas of policy.	All companies	Appendix 4
Securing value for money	Wholesale cost assessment and models	To provide stakeholders with greater transparency of our approach to wholesale price control costs, we have shared with companies, and published today, our suite of costs assessment tools used in the risk based review. The models will also support setting of price controls. We have also published summaries of our decisions for each company for the risk based review.	All companies	Appendix 5 and our website
	Menus	In this document, we set out important design features of cost incentive menus.	All companies	Appendix 5

Area	Issue	Summary	For which companies is this relevant?	Further information
	Retail cost allocation	We have set out a set of cost allocation rules for each company to use. This includes a standard set of cost drivers that companies must use for allocating their 2013-14 costs for the purpose of setting the wholesale and retail price controls, and also the household retail and non-household retail price controls from 2015-20.	All companies	Appendix 5 and '2014 price review cost allocation for retail and wholesale price controls'
	Default tariffs process and policy guidance	We explained in IN 14/01, 'Adapted approach for default tariffs' that our review of companies' default tariff proposals had been removed from the risk-based review and we were adapting the default tariff setting process. Today, we have published further guidance on the data all companies should provide and the approach they should take in developing their default tariffs. We are confirming that companies will have until 27 June to provide us with the information we need.	All companies	Appendix 5 and 'Setting price controls for 2015-20 – guidance for companies on producing default tariffs'

Area	Issue	Summary	For which companies is this relevant?	Further information
	Other revenue items	Most revenue companies receive relates to the provision of wholesale and retail water and wastewater services to end customers. But we sometimes need to take into account revenue from other sources. This document explains how companies should account for some specific revenue items will be dealt with in setting price limits. • Connection charges and infrastructure charges. • Land sales and rental income. • Water trading incentives.	All companies	Appendix 5
Balancing risk and reward	Inflation assumptions	In setting price controls we need to reflect actual inflation and make assumptions about forecast inflation in the 2015-20 price control period. In this document, we confirm the assumptions we expect to use. We will keep these under review and confirm the assumptions used in our draft and final determinations when we announce the determinations.	All companies	Appendix 6
	Risk and reward (RORE)	We have said that companies submitting information for a June or August draft determination need to take our 27 January risk and reward guidance into account. We provide further explanation of what companies should submit to us in this document.	Companies receiving June or August draft determinations	Appendix 6

Area	Issue	Summary	For which companies is this relevant?	Further information
Reconciling 2010-15 performance	Adjustments to 2015-20 price controls	We are providing further information on how 2015-20 price controls will reflect actual performance during 2010-15. This includes sector wide feedback on companies approach to 2010-15 performance in business plans and how we will deal with actual performance in 2013-14 and 2014-15.	All companies	Appendix 7 and 'Setting price controls for 2015-20 – further information for reconciling 2010-15 performance'
Business plan data	Draft determinations process	We are re-issuing the business plan tables and guidance to companies receiving a draft determination in June or August. We are also issuing some new business plan tables covering information not originally collected in business plans submitted in December 2013. All companies are expected to submit data for these new tables.	New tables are relevant for all companies Revised tables for companies receiving June or August draft determinations	Appendix 6, 7 and 8 and our website

List of appendices

Appendix 1: Our assessment of companies' business plans under the risk based review

In our pre-qualification decision document, we provided information on the key themes emerging from our risk-based review assessments. We explained that our review indicated many encouraging signs of progress. We think plans are generally of a higher quality than in previous price reviews – particularly in the way that companies are engaging with customers to deliver plans that reflect their priorities. We consider that the CCGs have played a key role in delivering higher quality plans along with the regulatory incentives. We said we would publish the detail findings from our risk-based review on 4 April.

We want to be as transparent as we can be for all stakeholders. We consider that this is key to protecting customers' interests and will help all stakeholders – including companies – respond to the outcomes of the risk-based review. To this end, we are publishing the material that our Board used to decide whether companies pre-qualified for enhanced status. For each company we are providing:

- a **company recommendation document**, covers the key points from the risk-based review assessment and our overall assessment for the company.
- **company dashboards**, which summarise our assessment for each company against each test for the retail household and non-household, wholesale water and wastewater and whole company elements of business plans; and
- **element scorecards**, which set out in more detail the rationale for our assessment against each test for the retail household and non-household, wholesale water and wastewater and whole company elements of business plans.

Each company received its own assessment on 24 March. We shared this information early so the companies could understand our assessment and begin preparation for submitting updated plans as early as possible.

The company recommendation document, company dashboards and element scorecards for each company are available on our website. We set out the tests applied to business plans in the pre-qualification decision document.

We have also published 'Setting price controls for 2015-20 – decisions on enhanced companies and next steps', which sets out our decisions for South West Water and Affinity Water.

To help stakeholders understand our conclusions, we have published '2014 price review risk-based review – internal methodology'. This includes scoring guidelines for each test, and was used to ensure we assessed plans in a fair and consistent way.

We used a **four-point scale** to score companies' business plans against our tests and 'other considerations'. We explain the four possible test scores below.

- **A** – where a company has demonstrated that it is **exceeding stakeholders' expectations**, and overall we consider that the evidence put forward is exceptional.

- **B** – where a company has demonstrated that it is has robustly addressed stakeholder's expectations, and we have received **sufficient and convincing evidence** to support companies' proposals.

- **C** – at this stage, we do **not** have sufficient and convincing evidence. More information is required for us to understand companies' proposals or to give us confidence that companies' will deliver proposals that protect customers interests.

- **D** – at this stage, substantially more information is required for us to understand companies' proposals and to give us confidence that companies' will deliver proposals which protect customers interests.

We scored each assessment criterion individually, and then assigned an overall score for each test. In most cases, we carried out separate tests for each element of companies' business plans (household retail, non-household retail, water wholesale and wastewater wholesale), but in some cases we applied the tests at a whole company level.

In some cases, our assessment has highlighted areas of companies' business plans where we do not have sufficient and convincing evidence at this stage: in these areas we have assigned C or D test scores. This does not necessarily mean we will require companies to adjust these areas of their business plans. In some cases, we expect that companies will be able to provide further evidence or information to give us confidence that their proposals are aligned with consumer interests and will be delivered efficiently.

In particular, the wholesale cost thresholds that we used during the risk-based review do not represent the baselines that we will use when setting the price control. In the case of some of these cost items, companies did not provide sufficient and convincing evidence for us to assess the costs through our risk-based review. It would be wrong to conclude that a gap between the thresholds we have used for the risk-based review and the company's business plan costs implies either that the company is inefficient or that we will ultimately disallow any of the costs put forward by the company. Gaps between our thresholds and company cost projections highlight areas where there are opportunities for the companies to provide further information and evidence.

Appendix 2: Equivalence of treatment for June and August draft determinations

In our pre-qualification decision document, we confirmed that non-enhanced companies will have the option of applying for an early draft determination in June, rather than August. They can either:

- submit new evidence by 27 June 2014 to **receive a draft determination on 29 August** in line with the existing price review timetable; or
- submit new evidence by 2 May 2014 to be considered for an **earlier draft determination on 25 June 2014**.

This revised process recognises that some companies may be in a position to submit information earlier than 27 June 2014, allowing us to make an earlier draft determination for such companies.

We do not expect that all companies will wish to apply for an earlier draft determination. They may prefer to take more time to consult with their customers, or to gather further evidence to support their business plans. Companies applying for an earlier draft determination should be confident that they have fully addressed our feedback on their business plans. Only business plans that meet our high quality bar will progress to a draft determination in June.

We consider that there will be procedural benefits associated with an earlier draft determination as it will allow companies to have clarity from the regulator earlier in 2014.

Final determinations published on 12 December will not be affected by whether the draft determinations were published in June or August.

In our decision document for enhanced companies, we explain that enhanced companies will benefit from our ‘do no harm’ approach. This approach applies in relation to their **absolute position at a point in time** and their **relative position** compared to other, non-enhanced companies. This ensures that enhanced companies are not penalised for submitting high-quality plans and receiving an early draft determination.

Our draft determinations are made on the basis of the information available to us at the time. In the case of companies that are not enhanced, new information will become available between the time that we set draft determinations for June companies and when we set the draft determination for August companies.

There will be a number of areas within the June draft determinations where conclusions are provisional, pending:

- the release of updated data;
- the outcome of parallel policy consultations; or
- confirmation of external circumstances.

As a result, there may be an improvement or deterioration in the company's position between draft determinations and final determinations to reflect such changes, consistent with the treatment of other non-enhanced companies or to reflect material changes in external circumstances.

Final determinations published on 12 December will not be affected by whether the draft determinations were published in June or August. Our approach to setting final determinations, including any updates to reflect material changes in external circumstances, will be the same for both June and August companies.

Appendix 3: Process going forward for June and August draft determinations

This appendix provides further explanation of the process for June draft determinations. It explains:

- the process companies should follow when applying for a draft determination;
- what companies need to provide to us, and when;
- how we will engage with all companies receiving June and August draft determinations; and
- the remaining steps through to the final determination.

A3.1 The process for applying for draft determinations

Companies will need to provide a gap analysis, on 17 April, to identify their readiness for 2 May submission if they want a June draft determination.

Companies should confirm by 17 April whether they intend to apply for a June draft determination.

In deciding whether to apply for a June draft determination, companies should consider the scale and nature of work required to address our feedback on their business plans, and whether they can complete such work within the accelerated timescales before 2 May.

To assess their readiness for submission, we require companies seeking a June draft determination to submit a 'gap analysis' by 17 April. This should indicate the areas in their business plans they have revised, or intend to revise, ahead of submitting their revised business plan information. It should also indicate how this additional information will bridge the gaps identified in our risk-based review – whether by providing more evidence (and, if so, what type of evidence), increased assurance, and/or by adjusting the substance of their business plan proposals where required.

We consider that this gap analysis will form a useful basis for dialogue between companies, CCGs and Ofwat. It will also help companies to consider whether a submission on 2 May will be feasible.

We will carry out a high level check to consider whether companies' submissions meet the gaps highlighted on 17 April.

We need to ensure that early draft determinations are in the interests of customers. Where a company indicates that it wants to receive a June draft determination, we will carry out a high-level check to confirm whether:

- the gap analysis covers the areas we identified in the risk-based review and addresses our other industry-level feedback and requirements, such as our risk and reward guidance; and
- the information provided in the revised business plan submission is then meeting the commitments set out in the gap analysis.

Based on this high-level check, we will engage with these companies to discuss whether there is a realistic prospect of proceeding to a draft determination in June.

We encourage companies to only submit their revised plans by 2 May if they are confident they have comprehensively addressed all of the areas highlighted in the gap analysis and through the risk based review. This will help ensure that companies retain ownership of their own plans and minimise the risk of regulatory intervention.

Companies that satisfy our high-level check will receive a June draft determination.

If companies' submissions satisfy our high-level checks, then we will start further engagement and dialogue with the company over the revised business plan submissions and move towards a draft determination in June.

Where a company's submission does not satisfy our high-level checks, it will not receive a June draft determination. Instead, it will follow the timetable for August draft determinations. We will use the information and evidence it submitted to us on 2 May to set its draft determination. We will not ask these companies to re-submit this set of revised business plan information on 27 June, although in addition to the minimum information updates we will need from all companies at this point in the process, we may seek further information from companies that sought a June draft determination in specific areas where it is in customers' interests to do so.

In such cases, submission of all relevant revised data on 27 June will need to reflect 2013-14 actual data and consequential revisions to forecasts.

Companies should not expect that business plans will be accepted in the round. If regulatory intervention is still required to protect customers, this will be reflected in our draft determinations. All companies will have the opportunity to make representations to Ofwat between draft determinations and final determinations.

August draft determinations.

We ask other companies only to confirm by 17 April that they intend to submit their business plans by 27 June. These companies will need to provide a gap analysis on 13 June, ahead of submitting their updated business plans.

This should indicate the areas in their business plans they have revised, or intend to revise, ahead of submitting their plans. It should also indicate how it will bridge the gaps identified – whether by providing more evidence (and, if so, what type of evidence), by increased assurance, or by adjusting their business plan proposals.

We consider that this gap analysis will form a useful basis for dialogue between companies, CCGs and Ofwat.

In re-submitting their business plans, companies should be confident they have comprehensively addressed all of the areas highlighted in the gap analysis and through the risk-based review. This will help ensure that they retain ownership of their own plans and minimise the risk of regulatory intervention.

Companies should not expect that business plans will be accepted in the round. If regulatory intervention is required to protect customers, this will be reflected in draft determinations. All companies will have the opportunity to make representations to Ofwat between draft determinations and final determinations.

A3.2 Information that companies need to submit

In section A3.1 above, we have explained that companies need to submit a gap analysis to us, either by 17 April or 13 June.

In our pre-qualification decision document, we said that companies that wished to receive a June draft determination needed to submit information to us by 2 May 2014. All other companies expecting to receive an August draft determination needed to submit information to us by 27 June.

We have re-issued business plan tables, but companies need to think carefully about the form of information and evidence that they should submit to us.

We have thought carefully about what information we should expect companies to submit to us. Resubmitting business plan data tables alone may not be sufficient where, for example, we identified insufficient evidence or support for an earlier business plan proposal. But, a full resubmission of the complete plan including all supporting information may not be proportionate to the findings of our risk-based review assessment.

So, companies should focus on:

- completing a comprehensive gap analysis;
- providing new evidence (in May or June) to address the gaps identified, and/or explaining any updated business plan information;
- providing updated business plan tables to reflect any new information and to meet our minimum requirements;
- explaining how they reflected the risk and reward package set out on 27 January in its updated business plan information; and
- explaining how each Board has sought assurance of the new information and evidence being submitted.

The specific information that companies should provide depends on the nature of changes to their business plan. As a guide, the minimum level of information we expect companies to provide for different types of updates is set out in table A1 below.

It is for each company to manage communications with its customers, but where proposed business plan revisions have significant implications for customers (for example, for future bills and services delivered), we encourage the clear communication of these to customers at the appropriate time.

Today, we have re-issued **business plan tables**. We explain these in more detail in appendix 8.are. Full tables can be found on our website. Companies receiving a June or August draft determination should submit all the re-issued tables, regardless of whether data has changed. But as we have explained above, any additional information submitted should focus on explaining revisions to data following the risk-based review

Table A1 Minimum requirements for business plan resubmission

<table>
<tr><th colspan="2">Summary of common requirements</th></tr>
<tr><td colspan="2">Updates to data tables (see appendix 8) and commentary that:
• complies with the commitments made in the gap analysis and therefore address the areas identified by the risk-based review/changes required by our risk and reward guidance and our price review requirements for all companies, and reflect CCG engagement; and
• forms a coherent, internally consistent, package.
This package of data should be complete for the purposes of our draft determinations. There can be no outstanding data or information to follow later (unless a later deadline has been announced by Ofwat).
Short form CCG report – which should focus on key gaps that were identified in the risk-based review and our risk and reward guidance.
Full Board assurance, including how the Board has assured itself that it has met the areas that were identified in the risk-based review and it should include where appropriate the use of third party assurance.
Companies are free to use their own financial models, but should also use our financial model. Companies should reconcile and explain any differences.</td></tr>
<tr><th colspan="2">Where changes are required in a particular category, our minimum requirements are shown below:</th></tr>
<tr><th>Category</th><th>Requirements</th></tr>
<tr><td>Customer engagement and willingness to pay (WTP) evidence</td><td>Companies providing further evidence on customer engagement and willingness to pay (WTP) should include an overview document that summarises the additional evidence provided against each criterion and how the company considers this meets the requirements for each criterion.
In particular, companies who did not pass this test should provide further evidence on how WTP data was estimated (including evidence to support that the WTP estimates are robust) and mapped to individual performance commitments and outcome delivery incentives (ODIs).</td></tr>
</table>

	Companies should justify how they have balanced their final proposed outcomes/performance commitments and incentives package.
Performance commitments	Companies should: • submit updated data tables and commentaries with clear mapping of the changes and additional evidence provided; • include a summary of changes at an individual performance commitment level and how the company consider this meets the requirements for each criterion; • explain why they have committed to the performance level and explain why they represent an appropriate level of stretch (as benchmarked against an upper quartile level of performance across the sector); and • for any new or updated proposed performance commitment, provide the same standard of supporting evidence as required as part of the risk-based review including any impact on costs.
Outcome Delivery Incentives (ODIs)	Companies should: • submit updated data tables and commentaries with clear mapping of the changes and additional evidence provided; and • include a summary of changes to outcome delivery incentives and how the company consider this meets the requirements for each criterion. In particular, companies should provide additional information in the following areas. • For ODIs where no financial incentives are proposed, a clear explanation of how customers are fully protected in the event of underperformance, including, where relevant, evidence that other regulatory sanctions are sufficient to protect customers. • Clear explanation for absence of financial rewards on individual ODIs. • Clear explanation of the WTP estimate, or other evidence of customer value, and incremental costs used to determine the incentive rate and where relevant how these have been aligned. • Use of appropriate scaling of incentives. • Clear justification for any neutral zones (or deadbands) based on uncertainty and other relevant considerations.

	• Evidence supporting the general approach to calibration with other incentives, as well as clear explanations where any individual ODIs depart from the standard approach. For any new or updated proposed incentive, the company should provide the same standard of supporting evidence as required as part of the risk-based review.
Wholesale cost assessment	Companies providing revised information on wholesale costs should ensure that this includes an overview document setting out and clearly referencing the following information. 1. A list of any new or revised claims for special treatment in the cost thresholds published on 10 March and updated on the 4 April. 2. A summary of any changes (including underlying reasons) to the overall level of totex from the December plan, consistent with the revised wholesale cost tables (as specified in appendix 8). 3. Taking full account of the January risk and reward guidance, a summary of any claims for the special treatment of specified wholesale cost items with respect to uncertainty mechanisms and/or cost sharing incentives. 4. Any more general representations on our approach to modelling, or the treatment of generic items across companies (for example, pension deficit recovery costs, business rates, third party costs, net/gross adjustments, competition costs). For each claim under (1) above, the company must: • for new claims, explain why the claim was not included or highlighted in the December 2013 business plan; • explain and fully justify changes from business plan cost levels and differences in its supporting evidence[1]; • explain and demonstrate why costs are not allowed for in the models that support the initial cost

[1] Without compelling information to the contrary, any increases in costs will be taken as prima facie evidence of a failure to provide robust and reliable information and the claim will not be considered further.

	thresholds, and, include a quantified estimate of any partial allowances; and • demonstrate that the cost estimates are robust and represent at least upper quartile efficiency[2]. For each claim under (3) above, the company must provide an explanation of how it is consistent with the principles set out in the January risk and reward guidance and compelling evidence to support the claim, including: • demonstrating that management have little or no control over the cost item or category; • justifying the central estimate and P10 and P90 estimates of costs; and • explaining how any proposed arrangements for special treatment with respect to cost sharing/uncertainty would be consistent with fully protecting the interests of customers. For each claim under (4) above, the company must provide: • compelling evidence that any new proposals would be superior to the existing approach, and, would reflect no more than upper quartile efficient costs and/or efficient levels of activity; and • evidence that the existing approach creates systematic bias – for instance, representations in respect of the forecasts of exogenous variables need to demonstrate that there is systematic bias in the forecasts not simply that the forecast of a small number of variables might not best reflect the circumstances of an individual company (in addition to demonstrating that proposed activity levels are no more than the efficient level, as noted above).

[2] Claims for programmes of spending will normally be required to clearly demonstrate compelling evidence of each of the following:
- need;
- CBA/optioneering – which should encompass compelling evidence that the lowest cost project (where appropriate taking account of whole life costs and wider costs and benefits) is being proposed, or, why the option under consideration is the only plausible option;
- cost estimate are robust and represent no more than efficient levels (if companies have third party or other evidence in support of programme costs they should provide this information); and
- customers are properly protected from non or under delivery (for example, by appropriately calibrated ODIs).

Retail cost allocation	We set out new rules for retail cost allocation in '2014 price review cost allocation for retail and wholesale price controls', which we published on 24 March. When submitting this information, companies should: • resubmit tables R3 and A19 based on these new rules; • resubmit the supporting detailed cost allocation tables for 2013-14 that we requested in our 6 January 2014 query[3] using the new rules for retail cost allocation. The company should include any supporting narrative that they feel is necessary to explain how they have allocated their costs between retail and wholesale and between household and non-household operating expenditure; and • obtain external assurance for tables R3 and A19 and the supporting detailed cost allocations. As we explained on 24 March, where a company is unable to follow the cost drivers set out in our new guidance for the allocation of all of its costs, it can carry out sample testing using the new rules and extrapolate the results of this to arrive at a best estimate for its allocations between retail and wholesale and/or household and non-household operating expenditure under the new rules. Where this is the case, the company should explain and obtain external assurance over the adequacy and representativeness of the sample that they have used as well as why they cannot comply with the new guidance and what action they are taking to meet the requirements of the new guidance.
Average cost to serve (ACTS) adjustments	Companies that are including adjustments to the ACTS in their submission should include an overview setting out and clearly referencing the following information. • What has changed in relation to the adjustments that are being requested relative to original business plans? • What additional or modified evidence is included to support the adjustments? • The impact of any changes to the value of adjustments on both the costs included in the ACTS calculation, and those included in the adjustment. • A record of any adjustments that have been removed from business plans.

[3] Clarification re: For action by Monday 13 January: Query – allocation of costs between wholesale and retail and household and non-household

	For any adjustment that did not achieve at least a 'B' score in our risk-based review of the December business plans, where we identified issues relating to evidence and the size of the adjustment identified in the risk-based review, the company should be satisfied that these issues have been addressed in their submission. Submissions should be completed using the revised tables and guidance.
Default tariffs	Companies should not include updated default tariffs or R4 tables in May submissions. Updated default tariff proposals should be submitted by all companies on 27 June.
Risk and reward	Companies should explain how the revised business plan information reflects the January risk and reward guidance and the updated table A20 (issued April 2014). Company submissions should be consistent with the guidance provided in appendix 6.
Affordability	Companies should explain how any issues identified in the risk-based review have been addressed and how any changes to customers' bills in AMP6 (and beyond) are consistent with customer preferences.
Financeability	Companies should provide Board assurance on the continued financeability of the business plan using the revised business plan information, based on both notional and actual structures with supporting evidence including scenario testing,
Adjustments to 2015-20 price controls	Companies should: • submit fully assured 2010-15 data for water and wastewater, including 2013-14 actual performance and updated 2014-15 forecast performance; • reconsider and evaluate 2010-15 adjustments taking into account company specific feedback and the updated performance information; and • ensure submissions use the revised tables and guidance (see appendix 8).

Board assurance of a high-quality business plan	Each company should provide a statement from the Board setting out how: • how it has assured itself that its plan is high quality (including any use it has made of independent third parties); • how the company will meet its obligations; and • within this the new information and evidence being submitted is high quality and addresses areas where further evidence is required.

Customer challenge groups (CCGs) have an important role to play for companies submitting information to us for June and August draft determinations.

In our pre-qualification decision document, we said that companies should work with their CCGs as they review their business plan.

The CCGs have made a significant and important contribution to the change in the culture of water companies, which will benefit customers. The value that the CCGs have added to the price review, particularly when compared to the approaches taken at previous reviews, is significant. We need to keep up this momentum and keep customers at the centre of the business plans.

We expect companies to engage with CCGs on revisions to plans and we have asked the CCG to provide us with a short-form supplementary report that addresses the key changes in the submission. The CCGs should decide what the short form report should look like, with regard to the gap analyses we have asked companies to submit to us.

It is important that companies have genuine dialogue with their CCG so that the CCG can understand what changes in the company's business plan proposal might be material to customers, where it needs to focus its challenge, and what it wants to come back and tell us.

A3.3 Engagement with companies

In our pre-qualification decision document, we said that we would publish detailed information and feedback on all company business plans to help companies review their plans ahead of draft determinations. We have now shared with companies, and publish today, our detailed assessments of business plans (see appendix 1) and assessment of wholesale costs (see appendix 5).

This information should help companies focus on the additional work they need to undertake ahead of draft determinations. But we recognise that direct engagement between companies and Ofwat will also help them understand what they need to address, and how they should do this.

We have thought carefully about how we could do this in a way that ensures any feedback or engagement is fair and consistent across all companies receiving June or August draft determinations. For the avoidance of doubt, engagement will not give companies assurance that issues where identified in the risk-based review have been fully addressed. Instead, it is intended to have a constructive dialogue to help the company take informed decisions about both the timing of its draft determination and to seek clarity around the issues that have been identified in the risk based review.

We propose that:

- companies can request working-level meetings to discuss issues related to the gap analysis;
- we will hold workshops across the elements of the business plan and run a query process; and
- we will meet with all companies as part of the draft determination processes once we have received the gap analysis.

A3.4 Process to final determinations

All companies and other stakeholders will have the opportunity to comment on the draft determinations for all companies.

Unlike previous price reviews, we will be setting draft determinations at different times depending on whether a company is enhanced (30 April), is able to submit a good quality set of business plan revisions in May (25 June), or submits its business plan revisions in June (29 August).

We will continue to run consultation periods at the time of each draft determination, but will not publish our subsequent final views on these until we set final determinations for all companies in December 2014.

Appendix 4: Information on focusing on delivery

A4.1 Service incentive mechanism (SIM) for 2015-20

In 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans' (our 'final methodology statement'), we said that we would continue to use SIM as an incentive to encourage all companies to improve the service that customers received. In October 2013 we consulted on:

- applying the SIM incentives to the price controls set for 2020 onwards (based on the performance during 2015-20); and
- the design of the SIM measures for 2015-20.

We said we expected to use the year 2014-15 to test the conclusions the October 2013 consultation reached on the SIM measures.

In our pre-qualification decision document, we explained the key conclusions on the SIM incentive properties. We confirmed that the SIM for 2015-20 will be similar in structure and form to the current incentive, but with more weight on the qualitative versus quantitative measures (3:1). We provided this information on 10 March to enable pre-qualified companies to make informed decisions about the contribution that the SIM incentive could make to their risk and rewards and to provide maximum certainty for 2015-20. We confirmed that the SIM incentive would apply to households for companies in England and Wales, and to non-households for companies who operate wholly or mainly in Wales.

In 'Service incentive mechanism (SIM) for 2015 onwards – conclusions' published today, we now confirm the measures that will form the SIM and set out a plan for their testing, including information about the development of:

- a small company service incentive; and
- an incentive for non-household customer service.

A4.2 Abstraction incentive mechanism, network plus incentive and network management incentive

The **abstraction incentive mechanism** (AIM) will no longer be part of the PR14 programme. Instead, it will be taken forward to slightly longer timescales in 2015. This is because of difficulties with the underlying data and information on the environmentally sensitive sites that AIM is intended to cover and the apparent diversity across companies in respect of sites and data. These issues will require intense and perhaps extended efforts to resolve, if any incentive arrangements are to be soundly based.

Attempting to do this alongside the challenging timetable of the PR14 programme does not appear realistic and would risk creating inappropriate and counter-productive incentives with respect to environmentally sustainable abstractions. Given the importance of environmental and sustainable development matters this does not appear an appropriate course of action. Also bearing in mind the importance of these matters we will work closely with the sector with the objective of properly resolving these matters in 2015.

This should facilitate the timely and rapid development of AIM as a national reputational incentive to benchmark, on a consistent basis, levels of abstraction at low flows from designated environmentally sensitive sites. We will take forward policy development through the Choice and Trading Arrangements project, which will ensure links to Government proposals for longer-term abstraction reform and upstream trading arrangements will be maintained.

One of the drivers for AIM was concerns that new water trading arrangements and incentives could create unbalanced incentives and encourage water companies to increase abstractions from unsustainable sources. Our final methodology statement provided a framework that would allow these concerns to be addressed independently of AIM – by the operation of Trading and Procurement Codes. These codes would make it clear that in order to qualify for a water trading incentive then the company concerned would need to demonstrate that any associated water abstractions were environmentally sustainable. We reconfirm these commitments and to the active enforcement of these conditions in the future.

Taken together, we are confident that these measures will lead to the development of robust and effective incentives with respect to sustainable abstraction.

The **network plus incentive** is designed to reveal information about costs and revenues related to companies' network and treatment activities on a consistent national basis, and the **network management incentive** is designed to reveal information about how companies manage their networks. We plan to take forward policy development in these areas through the Choice and Trading Arrangements project with further consultation with the sector taken forward in co-ordination with consultations on regulatory financial reporting.

Appendix 5: Information for securing value for money

A5.1 Overview of our approach to cost assessment

In order to set both wholesale controls, we need to estimate the efficient level of wholesale costs.

Wholesales costs are a very material proportion of water and wastewater company expenditure. Forming a view about the efficient level of these costs requires a detailed knowledge of the sector and of advanced cost modelling techniques.

In our final methodology statement we explained that we would move to a totex-based approach to assessing efficient expenditure for the next review. We made 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 bias towards capital intensive business solutions and expenditures.

We considered the move to totex could deliver substantial benefits for customers. However, implementing a totex approach is novel for the water sector. It has required us to revise our approach to modelling efficient wholesale costs. We have devoted considerable effort to the development and quality assurance of our wholesale cost models and have developed a range of technical, econometric models to facilitate the comparative assessment of efficiency.

It is difficult for CCGs or for customers to engage effectively with the companies on such matters. For this reason, and because of the inherent complexities of cost modelling, we have sought independent advice and quality assurance of our approach. Our costs models have been developed following industry consultation by our consultants, CEPA, and in conjunction with Dr Andrew Smith of the University of Leeds.

We are providing detailed information on the way we have modelled wholesale costs at this time: to provide transparency of our approach and decisions, to facilitate the preparation by non-enhanced companies for the 2 May and 27 June submissions, and to support constructive engagement on our approach to estimating the efficient level of costs. We want to encourage companies to engage with how the wholesale cost thresholds have been calculated. It is in the interests of both consumers and the companies that our assessment of efficient costs is robust.

Companies will inevitably have more information about their costs and the uncertainties associated with future cost forecasts than we do. This is one of the reasons (as explained in our final methodology statement) that we will set menus as part of water and wastewater price controls. Menus provide some additional flexibility in setting efficiency sharing factors and allow companies to better manage risk and rewards.

This appendix:

- explains the information we have released in relation to assessing the costs submitted in wholesale water and wastewater elements of business plans and how companies should respond;
- sets out our approach to baselines and menus for companies that are not enhanced;
- summarises our information on cost allocation for retail and wholesale price controls, published on 24 March 2014; and
- summarises our 'Setting price controls for 2015-20 – guidance for companies on producing default tariffs' published today.

A5.2 Wholesale cost assessment and models

When we published our pre-qualification decisions on 10 March 2014, we said that we would provide further information on wholesale cost thresholds and that we would publish our wholesale cost models.

We are in the process of calculating wholesale cost baselines, which feed into the price controls.

To calculate the cost thresholds we have used a series of wholesale cost models. We explain the suite of models we are using on in three overview documents (with appendices) as explained below. There are three broad steps underlying our approach to cost assessment for PR14.

- We have produced a **basic cost threshold** for each companies' water and (where relevant) wastewater activities. The basic cost threshold represents our initial view of the costs for a typical company of a certain size and certain characteristics. We calculate the basic cost threshold without reference to the company business plan. Costs for water and wastewater are derived from separate models which in turn draw on a series of supporting analysis and information. Today, we have published 28 company models populated with the basic cost thresholds.

- We have then carried out a **risk-based review of business plans and produced RBR initial cost thresholds**. In their business plans, each company had the opportunity to explain why the costs it faces may be different from the expected level of costs calculated by cost benchmarking models. We invited companies to explain why their costs were different to the rest of the sector or why these costs were different from the company's own historical costs. As we explained in appendix 1 of our pre-qualification decision document, gaps between our thresholds and company cost projections highlight areas where there are opportunities for the companies to provide further information and evidence on 2 May or 27 June. Today, we have published populated versions of the cost template models for those companies that scored D in the wholesale cost test (populated versions for other companies should be published shortly).

- Once companies have submitted any further information, we will review this evidence and decide whether any further adjustments are required to the cost thresholds and menu and price control baselines for each company.

In formulating draft determinations it will be important to modify the cost thresholds so that they can form the basis of menu and price control baselines. In general, this will involve three broad stages.

- Making any adjustments to take account of representations from companies and other stakeholders, and as a result of our further quality assurance process where these are consistent with protecting customers' interests.

- Considering whether it is appropriate to further protect customers in setting menu and price control baselines, in particular, for those companies with forecasts of costs below the cost threshold – this includes South West Water and Affinity Water.

- There are also a number of important but largely technical issues associated with translating cost thresholds into baselines and making sure that the final price control includes appropriate cost sharing incentives. These include the treatment of issues such as pension deficit recovery costs, business rates and transition spending.

In making any further representations on the cost thresholds and underlying modelling, it is very important that companies take into account the information set out in appendix 3.

A5.3 Setting menus

In our methodology statement, we explained we will set menus as part of water and wastewater controls. A menu provides a framework which allows companies a degree of flexibility to determine its price control baseline and cost sharing incentive rate. At the same time, it provides incentives for companies to be efficient and to reveal accurate information about their expectations of future costs.

Below, we present our non-enhanced menus for the water and wastewater wholesale price controls and discuss our calibration of their parameters. We provide more technical background to menus in A5.6, while A5.7 sets out the underlying parameters for the two menus.

Table A2 sets out our menu for companies that are not enhanced. The menu shows the rewards or penalties a company would earn for each menu choice for a given level of outturn expenditure. All values are expressed as a percentage of our baseline level of efficient expenditure.

Table A2 Draft menu for non-enhanced companies

Company menu choice	80	85	90	95	100	105	110	115	120	125	130
Cost sharing rate	54%	53%	52%	51%	50%	49%	48%	47%	46%	45%	44%
Allowed expenditure	95.00	96.25	97.50	98.75	100.00	101.25	102.50	103.75	105.00	106.25	107.50
Additional income	2.30	1.76	1.20	0.61	0.00	-0.64	-1.30	-1.99	-2.70	-3.44	-4.20
Actual expenditure	Reward/penalty										
70	15.8	15.7	15.5	15.3	15.0	14.7	14.3	13.9	13.4	12.9	12.3
80	10.4	10.4	10.3	10.2	10.0	9.8	9.5	9.2	8.8	8.4	7.9
85	7.7	7.7	7.7	7.6	7.5	7.3	7.1	6.8	6.5	6.1	5.7
90	5.0	5.1	5.1	5.1	5.0	4.9	4.7	4.5	4.2	3.9	3.5
95	2.3	2.4	2.5	2.5	2.5	2.4	2.3	2.1	1.9	1.6	1.3
100	-0.4	-0.2	-0.1	0.0	0.0	0.0	-0.1	-0.2	-0.4	-0.6	-0.9
105	-3.1	-2.9	-2.7	-2.6	-2.5	-2.5	-2.5	-2.6	-2.7	-2.9	-3.1
110	-5.8	-5.5	-5.3	-5.1	-5.0	-4.9	-4.9	-4.9	-5.0	-5.1	-5.3
115	-8.5	-8.2	-7.9	-7.7	-7.5	-7.4	-7.3	-7.3	-7.3	-7.4	-7.5
120	-11.2	-10.8	-10.5	-10.2	-10.0	-9.8	-9.7	-9.6	-9.6	-9.6	-9.7
125	-13.9	-13.5	-13.1	-12.8	-12.5	-12.3	-12.1	-12.0	-11.9	-11.9	-11.9
130	-16.6	-16.1	-15.7	-15.3	-15.0	-14.7	-14.5	-14.3	-14.2	-14.1	-14.1
140	-22.0	-21.4	-20.9	-20.4	-20.0	-19.6	-19.3	-19.0	-18.8	-18.6	-18.5

Note:

All figures, except for the cost sharing rate represent percentages of our baseline expenditure amount. Cells highlighted in blue represent the maximum reward that can be obtained for a given level of actual expenditure.

The precise calibration of menu parameters is provided in A5.7. The main considerations that led to the selection of these parameters are as follows.

A5.3.1 The cost sharing rate

The cost sharing rate provides companies with an incentive to reduce costs throughout the PR14 period and limits their exposure to cost overruns. The rate determines the share of any cost outperformance that the company's shareholders retain, and likewise, the share of any cost overrun that shareholders have to fund.

Our draft non-enhanced menu has a cost sharing rate of 50% at the menu choice of 100. We consider that this rate provides a strong incentive on companies to seek further efficiencies through the price control period, which will benefit current and future customers. This represents a strengthening of the averaged cost sharing rate used in PR09, but remains broadly consistent with regulatory precedent. A number of companies indicated their support for this rate in their business plan submission and no company rejected this rate, or proposed a different one.

We propose to limit the variation in cost sharing rate such that the rate does not significantly depart from our central value of 50%. The variation in our menus is of 2% for very 10% departure from our baselines.

A5.3.2 The break-even point

The menu framework requires us to set a break-even point. This is the point on the menu where revenues from cost outperformance (or underperformance) and the additional income are equal to expected outturn costs and the company would earn its allowed rate of return. We have calibrated the point defined by a choice of 100 and outturn cost of 100 as a break-even point. Given that our menu baselines reflect an historical upper-quartile efficiency level, a company that forecast to operate at that level of efficiency should expect to recover its normal rate of return.

This calibration was informed by our analysis of companies' expenditure forecasts. Analysis through the risk-based review suggests that around half the water and wastewater business elements are within a few per cent above or below the upper quartile thresholds. A higher break-even point would reduce the efficiency challenge of our totex framework and increase the likelihood of outperformance. For example, adopting a 105 break-even point would increase companies' revenue allowance by about 2.5% for a cost sharing incentive of 50%. This is equivalent to nearly £1 billion for the sector over the price control period.

We note that we used the same break-even point in the capital expenditure incentive scheme (CIS).

A5.3.3 Interpolation of Ofwat's cost baselines and companies' cost forecast to calculate allowed expenditure

In designing the menu framework, it is necessary to decide how much weight to put on our view of efficient cost and how much weight to put on the company's view of likely cost performance. In PR09 under the CIS, we attached a 75% weight to our cost baselines and 25% to companies' cost projections to calculate a capital expenditure allowance. Ofgem has used the same weighting scheme throughout all the price reviews that have used menu regulation. We propose to adopt a 75/25 weighting scheme above across our water and wastewater menus. The same weighting scheme will apply to enhanced and non-enhanced companies.

A5.3.4 The range of the menus

We set a lower limit for the menu at a choice of 80 (in other words, when the company's expenditure choice is 20% lower than our baseline view of cost). Based on the December business plans, we do not think that the lower limit will be a binding restriction for any of the companies. We propose to set the upper limit of the non-enhanced menu at 130 to allow a genuine choice, but within plausible bounds. While this upper limit is currently restrictive to two companies – there is one water and one wastewater company with an expenditure forecast that is over 30% higher than our cost baselines – we hope that further discussions and information from the companies concerned will lead to a reduction in the gap between our cost thresholds and the companies' forecasts of totex.

Table A3 below summarises the key parameters of our draft menus.

Table A3 Key characteristics of our proposed menus

	Non-enhanced menu	Enhanced menu
Cost sharing rate		
Value at 100	50.0%	55.0%
Slope (rate of change)	-0.2%	-0.2%
Break-even point at the 100 menu choice		
Outturn expenditure	100	100
Allowed expenditure weights		
Ofwat baseline	0.75	0.75
Company forecast	0.25	0.25
Range of choice		
Lower bound	80	80
Upper bound	130	115

Alongside this document we are also publishing an overview of the menu feeder model and the spreadsheets that capture the use of menus in our suite of feeder and financial models.

A5.4 Retail cost allocation

In March, we set out rules for each company to use to allocate costs between price controls in our information on cost allocation for retail and wholesale price controls. The rules include a standard set of cost drivers that companies must use for allocating their 2013-14 costs for the purpose of setting the wholesale and retail price controls and the household retail and non-household retail price controls from 2015-20. We also explained that companies should directly attribute costs between price controls wherever possible.

Ensuring that companies allocate their costs in a consistent manner across these boundaries is particularly important for the following reasons.

- The UK Government's Water Bill includes plans to allow all non-household customers in England to choose their supplier water and wastewater services by April 2017. This requires a robust and consistent allocation of costs, otherwise the relevant retail markets may be affected differently in different regions (for example, because companies use materially different cost drivers or allocation approaches). This could lead to an inconsistent operation of those markets or some non-household customers not being able to participate effectively in them. Also, in future, companies will need to ensure that they are compliant with their obligations under competition law. They will need to ensure that their non-household retail activities are able to operate as a viable and sustainable stand-alone business unit and there will be obligations to ensure that wholesalers treat their own and other retailers without preference.

- Some of our regulatory tools, such as the average cost to serve, are comparative. These tools must be applied fairly, and must use similarly defined costs.

All companies will be expected to have allocated their 2013-14 costs in line with the rules set out in our information on cost allocation for retail and wholesale price controls for the purposes of us making our final determinations in December for the period 2015-20.

A5.5 Default tariffs process and policy guidance

In IN 14/01, we explained that we were removing default tariffs from the risk-based review and would adopt an adapted process for setting default tariffs. Since then we have worked with companies to further understand the key issues in setting default tariffs.

Today, we have published guidance for companies on producing default tariffs. This provides clarification of the information that companies should submit to us on default tariffs and what companies should submit within the relevant business plan data tables as well as the approach that they should take in constructing their default tariffs. We have updated the business plan tables to ensure greater cross checking of data to reduce the scope for calculation errors.

All companies are required to submit the required information by 27 June 2014. We will set out our draft determinations for non-household retail price controls for all companies on 29 August. We will also describe the approach companies are taking to default tariffs. Final determinations for all companies will be set by 12 December with all non-household customers beginning the new control period (starting 1 April 2015) on the 'default tariffs'.

A5.6 Approach to revenue items

Most of the revenue that companies receive relates to the provision of wholesale and retail water and wastewater services to end customers. But we sometimes need to take account of other revenue companies receive so we can be sure that price controls properly reflect all the revenue that companies are likely to receive during the price control period.

In this price review, as outlined in our final methodology statement, we are continuing to use a **single till approach** for the treatment of revenues from regulated services regardless of the different forms of regulation we will be applying to particular regulated activities and services. This means that we assess all relevant costs and revenues associated with regulated activities and services in appointees' integrated businesses when assessing business plans and setting targeted controls for specific services.

For PR14, water and wastewater wholesale controls now cover all revenues from wholesale activities services, including revenues from **connection charges** and **infrastructure charges.** As we explained in our final methodology statement, this approach means we deduct the expected capital contributions when assessing companies' allowed wholesale costs (as we have done at previous price reviews).

In setting specific connection charges for services contributing to the total revenues covered by wholesale controls, such as connection charges, we would expect companies to continue to comply with their licence obligations to ensure that pricing is cost-reflective and non-discriminatory and also to comply with all their obligations under competition law. For example, if a company increased revenue in one area by unduly reducing connection charges in another area we may take corrective action through new wholesale and connection charging rules to ensure that companies returned these monies (with financing costs) to customers, as provided for under the Water Bill.

In our methodology statement, we explained that we would consult further at the time of draft determinations on the details of the form of the wholesale revenue controls, to allow companies more flexibility to adjust charges to deal with unexpected demand variations within the revenue caps, while protecting customers from undue bill changes from year to another. We also noted that we would consider the need to adjust the revenue caps themselves on a case by case basis in the event of exceptional unanticipated demand variations (for example, for new connections).

We will set out proposals for consultation alongside our draft determinations for enhanced companies later this month. Similarly, 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.

We will continue to take appropriate account of any other cash or revenue accruing to the regulated wholesale businesses, in setting the calibrating price controls (through allowed revenues) for those services covered by the K factor in companies' licences. This includes **income from land sales** and **rental income** whereby all water companies are required to share the proceeds of disposals of protected land (as defined in the Water industry Act 1991 – or 'WIA91') with customers. Consistent with our approach at the 2009 price review, we will make an adjustment at the 2019 price review (PR19) to ensure these proceeds are shared.

We will make adjustments to price control revenue at PR19 to take appropriate account of **water trading incentives**. As stated in our final methodology statement, if a water company wants to claim an export and (or) import incentive it must be operating consistently with and be able to demonstrate compliance with an approved trading and procurement code.

We will also claw back at PR19 any inefficient export profit from revenues which are not subject to the revenue cap which are not made pursuant to approved codes, and will set price limits on this basis at PR19.

A5.7 Technical background

A menu is a set of three equations of a single variable – the company's menu choice (see table A2). Each equation determines a different component of the menu: the cost sharing rate for each menu choice (also known as the efficiency incentive rate), the allowed expenditure for each menu choice and the additional income for each menu choice.

Table A4 presents the three menu equations using standard notation where **f** represents the menu choice – the ratio of a company's expenditure forecast to our menu baselines.

Table A4 The functional form of the three menu equations

Menu component	Type of function	Functional form
Cost sharing rate (R)	Linear	$\sigma_1 + \sigma_2 \mathrm{f}$
Allowed expenditure (AE)	Linear	$\gamma_1 + \gamma_2 \mathrm{f}$
Additional income (I)	Quadratic	$\alpha_1 + \alpha_2 \mathrm{f} + \alpha_3 \mathrm{f}^2$

The three components of the menu, in turn, determine the company's reward or penalty for every outturn of expenditure as follows.

Reward/penalty = (AE – outturn)*R + I

The additional income component of the menu is calibrated to ensure that the menu is incentive compatible, namely that it provides an incentive for companies to submit to us their unbiased forecast of expenditure over the price control period. In order for the incentive to work, however, a number of conditions have to be satisfied, most notably companies have to be risk neutral and our baselines must be obtained independently of companies expenditure forecast.

The calibration of the parameters in table A2 can be guided by some tangible policy decisions.

1. The rate of the cost sharing incentive at the central point of the menu (100) and the lower and upper value of the cost sharing rate across the menu. These determine σ_1 and σ_2.
2. The weights on the company view of cost and of the regulator's view of costs to be used in the calculation of allowed expenditure. These determine γ_1 and γ_2.
3. The break-even point at the central point of the menu (100). This determines α_1.

The parameters α_2 and α_3 will calibrate 'automatically' to retain the incentive compatibility of the menu.

A5.8 Calibrating our non-enhanced and enhanced menus

Table A5 Calibrating the parameters defining the non-enhanced and enhanced menus

Menu parameter	Notation	Non-enhanced menu	Enhanced menu
Efficiency incentive – constant	σ_1	0.70	0.75
Efficiency incentive – slope	σ_2	-0.0020	-0.0020
Allowed expenditure – constant	γ_1	75	75
Allowed expenditure – slope	γ_2	0.25	0.25
Additional income – constant	α_1	7.50	8.75
Additional income – first order parameter	α_2	-0.0250	-0.0375
Additional income – second order parameter	α_3	-0.0005	-0.0005

Table corrected on 11 April 2014.

Appendix 6: Information for balancing risk and reward

A6.1 Risk, reward and outperformance

In our pre-qualification decision document, we explained that companies submitting information for a June or August draft determination should take into account the risk and reward guidance we published on 27 January 2014.

As we set in our final methodology statement, we assess how well companies' business plans manage risk by the use of scenario modelling. As part of this, companies should provide an updated analysis of the possible range of financial outcomes from their business plan incentive proposals including the range for the return on regulated equity (RoRE).

Companies should include an updated table A20 of the business plan in their June or August submissions. This should be completed using the updated guidance provided today (see appendix 8 for further details on business plans tables). To allow us to understand the balance of risks and rewards in different elements of the business, and to validate the company's assessment, companies should provide as part of their June or August submission:

- high and low case scenarios for RoRE (based on P10 and P90[4]) at the appointee, wholesale water and wholesale wastewater level;
- high and low case scenarios for the retail margin for household and non-household retail[5];
- an Excel spreadsheet showing how the high and low case scenarios have been derived from their business plan;
- a breakdown the high and low case scenarios into each of the sources of risk identified in figure 8 of our guidance on risk and reward. These were:
  - cost risk, after cost sharing;
  - ODIs;
  - SIM; and
  - financing risk.

[4] The P90 and P10 are points on a risk distribution. The P90 points means there is only a 10% expected chance that the outturn RoRE will be above the threshold provided.
[5] For Welsh companies, non-household information is needed for the non-household retail risk test, and for all companies it contributes to our assessment of risk at the whole company level

Where companies have assumed performance in one area impacts on another – for example, if ODIs affect totex performance – this should be separately identified within the high and low case scenarios. High and low scenarios should take account of any uncertainty mechanisms.

Whenever possible, the risk assessment tool analyses risk on a consistent basis with the financial model. But we acknowledge that we have had to make simplifying assumptions in some areas. So, we are not requiring companies to use our risk assessment tool to develop their high and low scenarios, which should reflect companies' views on the potential balance between risk and reward. But to allow us to carry out a consistent assessment, companies should identify any differences (and the reasons for any differences) between the high and low forecasts for RoRE and retail margins set out in the company's submission, and those derived from our risk assessment tool.

Table A20 and the risk assessment tool are based on constant 2012-13 prices. Where companies consider that high and low scenarios should include different assumptions on inflation, they should consider how different levels of inflation impact on different cost and revenue lines. Inflation will impact on activities in different ways.

- Wholesale revenue – there should be no change as revenue is indexed to RPI.
- Retail revenue – this should be adjusted by the change in RPI as the revenue is constant in nominal terms.
- Wholesale and retail expenditure – the change will depend on whether expenditure is expected to increase by more or less than RPI.
- ODIs – change will depend on whether incentives are linked to RPI (whether directly or indirectly).
- SIM – this should be adjusted by the change in RPI as the incentive is defined to be constant in nominal terms.

A6.1.1 Cost recovery

Companies should set out their assumptions behind the 'pay as you go' (PAYG) ratios shown in table A19 of the business plan. This should include how they were derived from expenditure, where appropriate, and explain whether the PAYG levers have been used, for example, to meet financing requirements.

A6.2 RPI assumptions

When setting price controls we need to reflect actual inflation and make assumptions about forecast inflation in the 2015-20 price control period. Similarly, companies must make assumptions when they submit data to us.

We provided details of the published monthly Retail Price Index (RPI) values for the financial years up to and including 2012-13, plus the first two months of 2013-14 in business plan table A9. There are now published RPI values to February 2014, these are included in the updated table A9 for the business plan resubmissions.

In July 2013, we published guidance on the common assumptions for the 2015-20 price control period we wanted companies to use for their business plan scenario analysis in 'Economic assumptions for PR14 risk analysis'. These include projections for RPI inflation and other economic variables.

We have not seen any evidence to suggest that these RPI inflation assumptions need to be updated at the present time.

Table A6 summarises the historic RPI data and the forecast inflation rates for 2015-20 price control period. The figure included for 2014-15 represents the average of companies' assumptions and is taken from the business plan data submitted in December 2013.

We will continue to keep these assumptions under review and will confirm the assumptions used when we publish our draft and final determinations.

Table A6 Historic RPI and forecast inflation assumptions [2018-19 column added and 2019-20 value corrected on 11 April 2014]

	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
RPI: April – index (published)	242.5	249.5								
RPI: May – index (published)	242.4	250.0								
RPI: June – index (published)	241.8	249.7								
RPI: July – index (published)	242.1	249.7								
RPI: August – index (published)	243.0	251.0								
RPI: September– index (published)	244.2	251.9								
RPI: October – index (published)	245.6	251.9								
RPI: November – index (published)	245.6	252.1								
RPI: December – index (published)	246.8	253.4								
RPI: January – index (published)	245.8	252.6								
RPI: February – index (published)	247.6	254.2								
RPI: March – index (published)	248.7									
RPI: Financial year average – index (published)	**244.68**									
RPI: Financial year average – year-on-year % movement (actual)	**3.09%**									
RPI: Financial year average – year-on-year % movement (Ofwat assumptions)			**3.00%**	**3.40%**	**3.40%**	**3.50%**	**3.30%**	**3.10%**	**3.10%**	**3.10%**

Appendix 7: Information for reconciling 2010-15 performance

In our final methodology statement, we said that, we would adjust 2015-20 price controls to reflect company actual performance during the 2010-15 price control period.

Each company had to provide its view of its performance during the 2010-15 price controls in its business plan submitted on 2 December 2013. It had to explain what this would mean for the services for customers, and whether its revenues for 2015-20 should be adjusted to reflect actual performance. We assessed the way in which companies had done this as part of our risk-based review.

A7.1 Examples of good practice

The high-level results of our risk based review assessment were set out in our pre-qualification decision document. We explained that some companies had met all of our requirements by applying all of the incentive tools correctly and providing a full and frank account of their performance in 2010-15, including information explaining any differences between the PR09 determination and actual performance. Other companies had not met all of our requirements and would need to provide further information as part of the revised business plan submission.

Table A7 below summarises examples of good practice. We set out these examples to facilitate company preparation for submitting further information and to provide all stakeholders with transparency of our assessment of plans. Broadly, companies that were successful against our risk based review tests provided full and comprehensive evidence to support all of their proposed adjustments. These companies also followed our methodology closely and it was clear that they had fairly reflected their actual performance in their proposed adjustments.

Table A7 Examples of good practice in connection with incentive tools

Incentive tool	Examples of good practice
Service incentive mechanism (SIM)	Either a penalty or reward applied to represent the companies' view of how they performed. The basis for the reward or penalty is explained, including how it relates to guidance on the SIM, companies' performance, and the company's assumptions on the industry average. Calculations correctly reflect our methodology.
Revenue correction mechanism (RCM)	Variances between actual revenues and forecast revenues from 2010-11 to 2012-13 are fully explained. Revenue forecasts for 2013-14 and 2014-15 are consistent with the trend for the remainder of the period and fully explained. Such forecasts are justified, fair and reasonable. All models are completed (using the latest version of the model) and input data are accurate and explained. There is consistency between the data used in the company's populated RCM model and business plan tables.
Operating expenditure incentive allowance (OIA)	Companies use 2013-14 as the constraining year and apply the correct effective tax rate. Companies review and apply appropriate pension adjustments.
Change protocol (logging up and down, shortfalls, overlap programme)	Comprehensive information and supporting evidence on **all** FD09 outputs – for example, a separate and easily-identified chapter/appendix in the business plan which identifies and explains any differences between PR09 determination and actual performance (including outputs delivered, those delayed or no longer required). Individual logging up/down claims have evidence to support both the need and the basis of efficient costs for the adjustment. Comprehensive supporting evidence to justify serviceability judgements.

Incentive tool	Examples of good practice
Capital expenditure incentive scheme (CIS)	A full CIS true-up assessment is completed and submitted, and for merged companies the CIS true-up is assessed for each of the former operational areas. Where the CIS revenue adjustment is spread beyond 2015-16 the profiled adjustments are equivalent (in net present value – NPV – terms) to the single-year adjustment. Data in the CIS true-up fully aligns with the business plan information on capital expenditure and inflation assumptions. Commentary clearly sets out the scale of: • any reward or penalty due on the performance; • the revenue adjustments arising and how these are applied in the company's modelling of the 2015-20 allowed revenues; and • any RCV adjustments.
Other – tax and smoothing	Revenue adjustments are fully explained and supported by evidence including justifying the need and appropriateness of the adjustment with regard to the other relevant tools. Revenue adjustments associated with tax issues are supported by detailed explanation or an understanding of how these align with the overall company tax position. Revenue smoothing is NPV neutral. Where companies have proposed operating cost adjustments associated with company specific criteria, these are reviewed to ensure they reflect efficient costs.

A7.2 Overall timeline and submissions

Companies will now need to provide updated information on their proposed adjustments to 2015-20 price controls. Companies will need to:

- address issues identified through the risk based review process; and
- provide updated information on 2013-14 and 2014-15 performance as new information becomes available.

The adjustments we make to price controls to reflect 2010-15 performance are, in part, dependent upon company performance in 2013-14 and 2014-15. The different timing of the draft determinations means we have thought carefully about when we need companies to submit information to us in relation to performance in these two years.

Table A8 outlines our revised data requirements in relation to company performance in 2010-15.

Table A8 2010-15 company performance data requirements

Date	Data requirements by incentive tool	Companies required to submit data
2 May 2014	Information on SIM performance for 2013-14	All companies
2 May 2014	Updated information to address issues identified through the risk based review process and reflecting 2013-14 performance and updated 2014-15 forecasts. This includes information on RCM, OIA, change protocol, serviceability information and CIS (data for 2010-15, tables and models)	Companies seeking a June draft determination
27 June 2014	Updated information to address issues identified through the risk based review process and reflecting 2013-14 performance and updated 2014-15 forecasts. This includes information on RCM, OIA, change protocol, serviceability information and CIS (data for 2010-15, tables and models)	Enhanced and August draft determination companies

The updated performance information should accurately reflect the performance in 2013-14 and have robust forecasts in place for 2014-15. Submissions should be easily accessible, covering all the relevant tools, preferably within a single document and commentary covering ‘adjustments to the 2010-15 period’.

The three-year SIM comparative information submitted on 2 May will be used to determine rewards and penalties for draft determinations made in June and August. Ofwat will publish this comparative information on 29 August for all companies. We will update the SIM performance for enhanced companies where changes are material (because the enhanced companies' 30 April draft determinations can only use the two-year SIM comparative information).

We have published updated business plan data tables to collect the revised information we need, including some new tables, to allow us to collect information on company performance in 2010-15 to inform both draft and final determinations.

A7.3 How we expect to reconcile 2014-15 performance as part of the price review in 2020

At each price review we have to deal with the fact that actual performance in the final year of the price control is not known until after we make our final determinations. For this price review, while companies must make a robust assumption of expected performance for 2014-15, we take actual performance into account in price controls from April 2020 where it is materially different from the assumed performance. This process applies for all companies (including enhanced companies).

This mainly affects:

- the RCM – we will carry out a reconciliation in the summer of 2015;
- the change protocol and serviceability – we will review these in the summer of 2015; and
- the CIS – this will be reconciled in the summer of 2016.

The RCM reconciliation will require companies to submit actual revenue information in the summer of 2015, which will be reconciled using the same legacy tools and mechanisms used within the price review.

The change protocol and serviceability review will require companies to submit information identical to that sought through PR14 about the delivery of the FD09 outputs and serviceability measures for 2014-15. Any material differences between FD09 outputs and actual deliverables will then be reconciled through the CIS reconciliation in the summer of 2016. This reconciliation will not affect PR14 price controls and any changes (where material) will be applied through the following price review in 2019-20.

Finally, the CIS reconciliation will examine differences between outputs and costs against FD09 assumptions, taking into account final COPI indexation and will determine final rewards and penalties for the CIS, with final revenue and RCV adjustments being determined. Where these are materially different to those assumed at the PR14 final determination then the differences will be reconciled at the following price review in 2019-20.

More detailed information on our approach to adjusting 2015-20 price controls, including more detail on our updated information requirements, is provided in our document on reconciling 2015-20 performance, which will be published shortly.

We will consult shortly on the appropriate mechanism for managing differences between actual and forecast wholesale revenue in the next regulatory period consistent with the basic form of wholesale control set out in our final methodology statement.

Appendix 8: Updating business plan data tables

Companies submit **business plan data tables** which we use to set price controls.

We are re-issuing the business plan tables and guidance to companies receiving a draft determination in June or August. We carried out a similar exercise ahead for pre-qualification companies' submissions on 17 March.

- The revised tables resolve some identified errors and provide for greater validation of the data submitted by companies.
- There are some tables that we do not need any new information from any companies because we either no longer need data, or know that data won't change.

Exactly which tables companies need to submit will depend on whether the companies are enhanced. Companies receiving June or August draft determinations should submit the complete pack of tables; but the extent to which the data will change relative to previous submissions will depend on how we assessed their business plans against the tests for the risk based review. For example, where non enhanced companies performed well against particular areas of the risk-based review (for example, wholesale costs), they may not need to modify business plan data. Companies should also consider the guidance provided in appendix 3.

We have also added seven new tables not originally collected in business plans submitted in December 2013. These relate to new SIM and asset performance data and a reconciliation legacy adjustments of which we need in order to make adjustments for company performance in 2010-15. All companies are expected to submit data for these new tables (see appendix 7 and our document on reconciling 2015-20 performance.

Further information on the business plan tables and associated guidance can be found on our website.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We are responsible for making sure that the water sector in England and Wales provides customers with a good quality and efficient service at a fair price.

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