April 2013

Water today, water tomorrow

Setting price controls for 2015-20 – business planning expectations

A consultation

OFWAT

About this document

In 'Setting price controls for 2015-20 – framework and approach: a consultation', which set out our proposed methodology for the 2014 price review, we confirmed our intention to implement a risk-based approach to reviewing business plans. This consultation sets out the detail of our proposed risk-based reviews and our expected data requirements that will need to be submitted alongside companies' business plans.

Our methodology consultation was part of a series of consultations for the 2014 price review and was based on the principles set out in 'Future price limits – statement of principles'. It was also informed by informal and formal consultations, including our:

- 'Consultation on retail price controls for the 2014 price review'; and
- 'Consultation on wholesale incentives for the 2014 price review'.

The views and input we have received so far have been invaluable and we look forward to continuing a productive engagement with, and involvement of, all our stakeholders.

Our new approach to reviewing business plans described in this document gives companies greater freedom to innovate and to find the best way to present their plans. It also firmly places the responsibility to ensure that plans are high quality with company Boards, and outlines reputational, financial and procedural incentives for high-quality business plans.

By a **'high-quality business plan'**, we mean a plan that:

- is designed to deliver good outcomes for customers and the environment, and ensures companies meet their statutory obligations;
- contains accurate and efficient projections and estimates without inflated costs;
- is not a 'bid' and does not seek to game the regulatory process; and
- contains fairs proposals to share 'pain and gain' with customers.

We invite comments and submissions from interested parties by **23 May 2013** to help us develop and finalise our proposals for publication in summer this year. We will run workshops during the consultation period to allow stakeholders additional opportunities to input, shape our proposals, and give us their views and comments.

Our methodology consultation has only recently closed, and we have not yet completed our consideration of the responses. In taking our decisions on our final business planning expectations, we will also need to take account of any changes to our proposed approach to setting price controls for 2015-20 – these will be set out in our final methodology statement, which we expect to publish in early summer 2013.

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Key messages

- Our risk-based approach to reviewing companies' business plans for the next price review is new and will strongly encourage companies to focus on their customers rather than the regulator.

- Companies with the best business plans will have engaged actively with their customers and stakeholders. Their plans will clearly show how they have taken customers' needs and wishes into account while meeting their statutory obligations.

- The independent customer challenge groups (CCGs) are a new and powerful forum through which companies can engage with all of their customers, including bill payers and environmental regulators.

- We would expect the CCG reports to highlight both consumer and environmental concerns and how companies have addressed these – the views of the independent CCG will be crucial in our risk-based review.

- We propose using one of three categories to assess companies' business plans – 'enhanced', 'standard' and 'resubmission'. We expect all companies to work hard to try to fall into the first two categories. But we are proposing the option of the third category for any company that submits a business plan with serious shortcomings.

- While it will be a high standard to meet, the companies that receive enhanced status will have greater rewards – in the form of lighter-touch procedures, earlier decisions and financial incentives. We know that external stakeholders, especially investors, highly value how Ofwat assesses companies, so these companies will also benefit from an enhanced reputation, including with capital markets.

- We will continue to work with our stakeholders including the other regulators – specifically the Environment Agency, the Drinking Water Inspectorate and Natural Resources Wales – as we progress the price review.

Consultation questions

Throughout this consultation, we raise a number of specific questions, which we have summarised here. As well as responses to these specific questions, we welcome views from stakeholders on any of the issues we raise in this document.

An incentives-based price review process

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

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

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

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

The risk-based review in detail

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

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

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

Delivering focused information requirements

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

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

Application to small companies

Q10 Do you agree with our proposal to continue to set price limits for new appointees using a relative price control? If not, what alternative do you prefer?

Q11 Do you agree that we should set Cholderton & District Water its own simplified price control?

Q12 Do you think that we should develop a new small company service incentive? If so, what form do you think this incentive should take?

Q13 Do you agree with our proposal that small water companies should not be subject to separate wholesale and retail price limits?

Q14 New appointees are growing in size. In the future do you think that we might need to adopt a different approach to regulating their prices and service? If so, what circumstances should prompt a change of approach?

Responding to this consultation

We welcome your responses to this consultation by **23 May 2013**.

We will use responses to this consultation to inform our decisions on our final business planning expectations, which we will publish in summer 2013.

You can email your responses to stephen.stpier@ofwat.gsi.gov.uk or post them to:

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Ofwat
Centre City Tower
7 Hill Street
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If you wish to discuss any aspect of this consultation, please contact Stephen St Pier on 0121 644 7801 or by email at stephen.stpier@ofwat.gsi.gov.uk.

We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished. Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004.

If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory ‘Code of Practice’ which deals, among other things, with obligations of confidence. In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information, we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on Ofwat.

1. Executive summary

Over the past two years, we have been developing our approach to setting price controls for each of the five years between 2015 and 2020. We have engaged extensively with stakeholders on our approach to put the onus on companies to focus on their customers rather than on the regulator.

This consultation sets out how, in line with our future price limits principle of **'ownership, accountability and innovation'** we are making a step change away from a prescriptive approach to business plans. Our approach is a response to feedback, including the 2011 'Review of Ofwat and consumer representation in the water sector' (the 'Gray review'), that both companies and Ofwat need to change their approaches to business plans.

Included in the conclusions of the Gray review were three that are particularly relevant to this document. The review said that Ofwat:

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

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

Our new approach places the onus on company Boards to own and be accountable for plans. We do not intend to issue detailed and prescriptive guidance explaining how companies should structure or present their business plans. Instead, we propose to focus on creating strong incentives for companies to submit high-quality plans.

This change should give companies the opportunity to innovate and develop business plans that better reflect their customers' priorities and their particular circumstances. In turn, customers should benefit as companies focus more on delivering what they want and need.

We propose to introduce **reputational, procedural and financial incentives** for companies to produce high-quality business plans.

1.1 An incentive-based price review process

We want to create strong incentives for companies to submit a **high-quality business plan** – by which we mean a plan that:

- is designed to deliver good outcomes for customers and the environment and ensures companies meet their statutory obligations;
- contains accurate and efficient projections and estimates without inflated costs;
- is not a 'bid' and does not seek to game the regulatory process; and
- contains fair proposals to share 'pain and gain' with customers.

The plan should also come with a high level of assurance in the form of a statement from the company's whole Board that the plan is of a high quality, as described above, that estimates and data have been arrived at appropriately, and independently of other companies and competitors. In assessing business plans, we will take into account what company Boards say about how confident they are that they have submitted a high-quality plan.

In line with our preferred option – set out in more detail in chapter 2 – we expect companies to submit a **business plan** that covers all regulated activities, but which also sets out their proposals by each of the price controls we intend to set – household retail, non-household retail, water wholesale and wastewater wholesale. We use the term **'business plan element'** (or **'element'**) to refer to the parts of a company's business plan that align to the separate price controls.

We propose to make available specific **reputational, financial and procedural** incentives linked to our view of the quality of business plans.

1.1.1 Assessing business plan quality

Our assessment of the quality of business plans will be through a **risk-based review**, which we explain in more detail in chapter 3. We will assess companies' business plans against a number of factors – some that look at companies' proposals for individual business plan elements, and others that look at the overall plan.

We propose using the risk-based review to:

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

The company category is determined by the lowest result of for any element and company-level checks such as for financeability and affordability.

Our preferred approach is to determine company categories early in the process and publish the results for all companies. We consider this would create appropriate **reputational incentives** for high-quality business plans. A number of stakeholders, particularly investors, have told us that they put significant weight on Ofwat's assessment of companies when they themselves assess companies. So we consider that publishing the category results for each company will create strong reputational incentives by giving a clear signal to investors and other stakeholders to allow them to identify those companies that have – or do not have – high-quality plans and can expect to benefit accordingly.

As the Gray review concluded, there needs to be considerable change on behalf of both Ofwat and the companies if we are to – jointly – change the culture of previous reviews where companies were overly focused and cautious about meeting tightly specified regulatory guidelines – but no more than meeting them. So we do not intend to set out, in advance, our assessment thresholds used in the risk-based review.

Assessing business plan quality – preferred options for consultation

For each company, we assess the quality of each element in its business plan separately, allocating it to one of three processes which determines the level of scrutiny and challenge for that element:

- enhanced;
- standard; and
- resubmission;

The company receives an overall company category – enhanced, standard or resubmission – that determines procedural and financial rewards. The company category is determined by the lowest result of any single element and company-level checks such as financeability and affordability.

To create appropriate reputational incentives, we propose to publish the company category results early in the price review process.

We are also consulting on possible variations, such as only using enhanced and standard processes, and the timing of the announcements of the company categories.

1.1.2 Challenging companies' proposals

We propose that the nature and extent of our scrutiny and challenge to each element of each company's business plans should be determined by the process to which we assigned the element in the risk-based review – the higher the result from the quality assessment, the lighter the scrutiny will be. We are taking this approach both to create **process incentives** for high-quality business plans, and to ensure that we focus our challenge and scrutiny where it is most needed.

Table 1 Tailoring our approach to scrutiny and challenge

'Process'	Approach to scrutiny and challenge
Enhanced	We expect that elements that are rewarded by an enhanced process will be of a very high quality and very well evidenced. We propose that enhanced elements would be accepted in the round. This would mean that the company's proposals would be substantially unchanged for this element in draft determinations.
Standard	Business plan elements that are placed in a standard process while being acceptable as very good quality, will have fallen short on some tests. They will face greater scrutiny than enhanced elements and we will carry out a more in-depth review of these standard elements.
Resubmission	We intend to put elements in the resubmission process if we identify serious shortcomings in a company's proposals such that for this element the plan should returned to the company to be reworked. We think it is appropriate that resubmission elements are subject to the most intensive scrutiny and challenge.

1.1.3 Setting controls

As well as allocating each element to one of these processes, the company's overall plan would be assigned to **enhanced, standard or resubmission company categories.** This would be determined by the lowest result from the assessment of the individual elements and company-level affordability and financeability checks. So, for example, a company with one element placed in a resubmission process would receive a **resubmission company category**.

A decision on the company categories would determine the availability of some reputational (as described earlier), procedural and financial rewards.

- **Enhanced companies** are likely to receive early draft determinations, and qualify for additional financial incentives such as an enhanced menu with more attractive incentive rates.

- **Standard companies** would follow the standard process for setting price controls, and have access to standard incentives.

- **Resubmission companies** would face a delayed draft determination, and may face less attractive incentive rates in a menu, or Ofwat may set the incentive rate without using a menu.

Setting price controls – preferred options for consultation

We create financial and procedural incentives that depend on the overall category of a company.

- Enhanced category companies receive an **early draft determination**, as well as **additional financial incentives** – which may be in the form of an enhanced menu.
- For standard category companies, we publish draft baselines, and then draft determinations alongside final baselines.
- Companies in a resubmission category may **face a delayed draft determination, and less attractive financial terms** – which may be in the form of a menu that is less attractive than those used for the other categories, or Ofwat may set the incentive rate without using a menu.

1.2 The risk-based review

In order for our incentives to be effective, we need a robust approach to assessing business plan quality. This approach is our **risk-based review**. For the risk-based review, we propose to take a staged approach that looks at four key areas of companies' proposals for 2015-20.

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

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

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

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

We will also need to look at companies' **performance in 2010-15** – with a particular focus on how the outcome of the incentives from the last price review and any differences between actual and expected performance should be reflected in prices for 2015-20.

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

1.2.1 Board business plan assurance

We want each company's Board to own and be accountable for the business plan they submit for the 2014 price review. This is consistent with our wider policy set out in 'Delivering proportionate and targeted regulation – Ofwat's risk based approach'.

To be considered alongside the tests, we propose to require that whole company Boards – not just one or some executive member(s) – provide an assurance statement that the plans are high-quality plans. This statement should be in a Board's own words, and we will take it into account when we assess the plan.

We do not intend to prescribe or provide detailed guidance on the approach companies should take to business plan assurance. This is a significant shift away from the more intrusive, and prescriptive, approach, to assurance of previous price reviews. Before Boards sign off business plans, they should put in place any processes that they consider they need in order to be assured that they are submitting high-quality plans.

As part of this process, and as part of the specific assurances we propose to require from them around outcomes, we expect Boards to demonstrate that companies are operating transparently, and Boards are providing adequate leadership to the company submitting the business plan and are complying with both the Financial Reporting Council's 'UK Corporate Governance Code' and the relevant licence conditions.

The risk-based review – preferred options for consultation

We use tests that focus on the key areas of:

- outcomes;
- costs;
- risk and reward; and
- affordability and financeability.

We require assurances from companies' whole Boards that they have submitted a high-quality plan, and that companies are operating transparently and Boards are:

- showing good leadership to the company, and
- in compliance with both the Financial Reporting Council's 'UK Corporate Governance Code' and the relevant licence conditions.

1.3 Delivering focused information requirements

We want to step back from the detailed and prescriptive business planning guidance we have issued for previous price reviews, and focus instead on the key information and data we will need to set price controls. This should help us deliver a targeted and proportionate price setting process.

So, we propose that companies should provide an overall **business plan narrative** that explains their proposals for 2015-20, and how they arrived at them. But it will be for companies' Boards to determine the best way to present their proposals – we do not want to constrain companies' approaches by issuing prescriptive guidance or templates that they should follow.

Of course, it will be important that business plans and the narrative provide a persuasive vision for the future which is supported by compelling evidence. A company that submits clear, well-reasoned evidence – which is in a form accessible to us, customers, customer challenge groups (CCGs), and other regulators and stakeholders – will be more likely to have its proposals accepted than a company that does not.

We propose that companies should provide a common set of **supporting data tables** and associated commentaries alongside their business plan narratives. In setting out the data that we intend to collect, we have been careful to make sure that we specify the right amount of data – which is all the data we need to set price controls, but not more than we need. We have reviewed our proposed requests carefully against the processes and analysis that we expect to carry out.

The risk-based review set out in chapter 3 is a key part of delivering a more proportionate and targeted price setting process. Companies with very high-quality plans, which qualify for the enhanced category, can expect a reduced data burden compared with previous price reviews. But we may need to require additional information and data from companies with poorer quality plans.

We are also asking companies' CCGs to submit their reports alongside business plans. **CCG reports** will provide us with important information about the quality of companies' customer engagement, and how well the companies' business plans reflect customer views and priorities. They will form a key input to our risk-based review.

To help us update, test and refine our cost assessment tools ahead of business plans – better accuracy of the models will help the processes run more smoothly to the benefit of both Ofwat and companies – we will be collecting a limited amount of cost data for 2010-15 in August 2013 (the '**August submission**'). All of the data we request for this submission should be straightforward to collect.

Delivering focused information requirements – confirmed direction

We will request a small, focused data submission in August 2013 to enable us to refine our cost assessment tools and assess SIM performance.

Company Boards are responsible for signing off the august data submission, and determining the processes they need to do this.

Delivering focused information requirements – proposal for consultation

Business plans should include a business plan narrative that explains the company's proposals – we do not intend to specify the form or content of this narrative.

Business plans for 2015-20 should also include supporting data tables – the content of which we are now consulting on.

Company Boards are responsible for signing off the business plans, including the supporting data tables, and determining the processes they need to do this.

1.4 Application to small companies

The ten water and sewerage companies, and the eight largest water only companies, have provided water and sewerage services to the vast majority of customers in England and Wales since privatisation. The smallest of these 18 **'incumbent companies'** has about 120,000 customers.

The remaining customers in England and Wales receive their supplies from what we call the **'small companies'**:

- Cholderton & District Water – the only other incumbent water only company, which has about 700 customers; or
- One of the five **'new appointees'** – companies that started providing water and sewerage services to customers after privatisation. The largest of the new appointees currently has about 2,000 customers.

These small companies have the same legal duties and responsibilities as the large incumbent companies, and we have the same statutory duties to protect their customers and secure that they can finance their functions. The legislative changes proposed by the UK Government in its Draft Water Bill will also allow all non-household customers served by small companies in England to choose who provides their retail service.

The small companies are all significantly smaller than the 18 largest incumbent companies. So, in line with our future price limits principle of **'proportionate price setting'**, we propose to reflect this significant difference in the approach we take to both **setting price controls** and **business planning** for small companies. In particular, we propose that we should:

- continue with our existing approach of setting a simplified price control for Cholderton & District Water, based on a simplified business plan that is assessed outside of the risk-based review; and
- consider introducing a small company service incentive for all small companies.

Application to small companies – preferred options for consultation

For all small companies we propose to:

- not set separate wholesale and retail price controls for small companies at this stage
- continue with our existing approach of capping new appointees' charges at the level of the equivalent charges for the incumbent whose area they operate in
- consider whether to develop a small company service incentive

Specifically for Cholderton & District Water, we propose to:

- continue setting a simplified control; and
- adopt a simplified process for setting its control, including a simpler business plan.

1.5 Next steps

This consultation closes on 23 May 2013. We will use responses to this consultation to inform our decisions on our final business planning expectations, which we expect to publish in summer 2013.

In taking our decisions on our final business planning expectations, we will also need to take account of any changes to our proposed approach to setting price controls for 2015-20. We will set these out in our final methodology statement, which we expect to publish in early summer 2013.

We are continuing our programme of engagement over our approach to setting price controls for 2015-20 during the consultation period. This includes stakeholder workshops covering key issues raised in this consultation. We will take account of all stakeholder feedback, including from these workshops, in our decisions on our final business planning expectations.

In our methodology consultation, we explained that implementing effective menu regulation for wholesale price controls creates a tightly-constrained timetable for delivering price controls in 2014.

Implementing menus effectively could create significant benefits for both companies (which would receive greater control over their allowed wholesale costs) and customers (as it encourages companies to present their best possible cost forecasts). Our preferred option remains to use menus for wholesale controls, and we continue to work with stakeholders to agree an effective and deliverable timetable.

One option we are considering is an **earlier date for submitting business plans – 2 December 2013**. This would allow more time for:

- engagement with companies, CCGs and other stakeholders, particularly during the risk-based review. This should allow us to make more robust decisions on the need for resubmissions, and may result in fewer resubmission plans;
- decisions on companies' proposals; and
- companies and CCGs to respond to our proposals, including making menu choices.

We will need CCGs' reports to carry out our risk-based review. So bringing forward the date for submitting business plans would also mean asking CCGs to provide their reports to us earlier – alongside companies' business plans on 2 December 2013. We expect companies to ensure that CCGs have sufficient sight of their final plans, including any late, material changes, to achieve our submission deadline.

2. An incentive-based price review

Summary

Until this price review, our approach to business planning had grown more and more prescriptive, and our requirements and guidance for companies' business plans had become more extensive and detailed.

This meant that companies' business plans became increasingly constrained by our requirements reducing company ownership of, and accountability for, their proposals. So instead of business plans being a response to the demands of companies' customers, they were a response to the demands of the regulator. And companies had weak incentives to innovate or do more than the minimum required by our guidance.

This was recognised in the 2011 'Review of Ofwat and consumer representation in the water sector' (the 'Gray review'):

> **"Ofwat goes too far into the detail of company business plans and that, as a result, the companies are very Ofwat-focussed and very cautious and conservative in their approach. Rectifying this will require a substantial change of approach by both Ofwat and the companies it regulates."**

This consultation sets out how, in line with our future price limits principle of **'ownership, accountability and innovation'**, we are making a step change away from a prescriptive approach to guidance on business plans. This is because we want to place the onus on company Boards to own and be accountable for plans, and have more freedom to design those plans to deliver the best long-term sustainable solutions for their customers and the environment.

So **we do not intend to issue detailed and prescriptive guidance** that explains how companies should structure or present their business plans. Instead, we focus on creating the strongest incentives for companies to submit high-quality business plans, and focus our guidance on the information and data we will need to make determinations. This gives companies freedom to innovate and develop business plans that better reflect their customers' priorities and their particular circumstances.

By **‘high-quality business plan’** we mean a plan that:

- is designed to deliver good outcomes for customers and the environment and ensures companies meet their statutory obligations;
- contains accurate and efficient projections and estimates without inflated costs;
- is not a ‘bid’ and does not seek to game the regulatory process; and
- contains fair proposals to share ‘pain and gain’ with customers.

The plan should also come with a high level of assurance in the form of a statement from the company’s whole Board that the plan is of a high quality (as described above), and that estimates and data have been arrived at appropriately, and independently of other companies and competitors.

In assessing business plans, we will take into account what company Boards say about how confident they are that they have submitted a high-quality plan. Of course, nothing in our decisions in the risk-based review would reduce the likelihood of future investigation possibly leading to enforcement action that we, or other regulators, might do if a company is suspected of being in breach of a statutory obligation.

In line with our preferred option (set out in more detail below), we expect companies to submit a **business plan** that covers all regulated activities, but which also sets out their proposals by each of the price controls we intend to set:

- household retail;
- non-household retail;
- water wholesale; and
- wastewater wholesale.

We use the term **‘business plan element’** (or **‘element’**) to refer to the parts of a company’s business plan which align to the separate price controls.

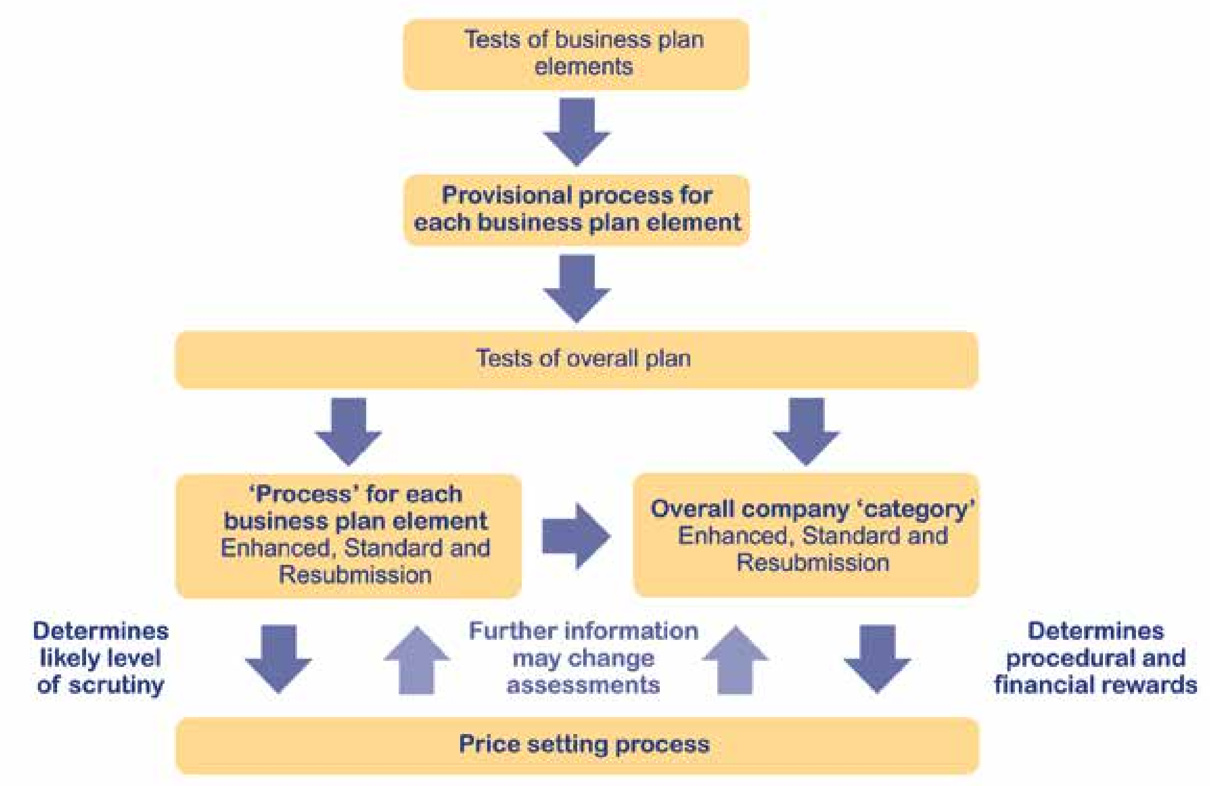
We think that in a sector where customer choice is limited, it is important that the regulator looks to strengthen the incentives on companies to deliver high-quality business plans. We propose to encourage high-quality business plans by providing specific reputational, financial and procedural incentives linked to our view of the quality of business plans.

Our assessment of the quality of business plans will be through a **risk-based review**, which we explain in more detail in chapter 3. We will assess companies' business plans against a number of factors – some which look at companies' proposals for individual business plan elements, and others which look at the overall plan.

We propose using the risk-based review to:

- assign each element of each company's business plan to one of three **processes** – enhanced, standard or resubmission – which determines the likely level of scrutiny and challenge of that element; and
- assign each company to one of three **categories** – enhanced, standard or resubmission – which determines procedural, reputational and financial rewards (see figure 1).

Figure 1 Stages of the risk-based review



Our preferred approach is to determine company categories early in the process and publish the results for all companies. We consider that would create additional appropriate **reputational incentives** for high-quality business plans. We expect companies that receive recognition by being placed in an enhanced category will benefit because investors and other stakeholders are able to clearly identify them as companies that have regulatory approval of their very high-quality business plans.

As the Gray review concluded, there needs to be considerable change on behalf of both Ofwat and the companies if we are to – jointly – change the culture of previous years where companies were overly focused and cautious about meeting tightly specified regulatory guidelines – but no more than meeting them. So we do not intend to set out our assessment thresholds in advance. Nor do we propose to provide detailed information about our tests that might allow companies to estimate those thresholds.

We illustrate this approach in figure 2 below.

Figure 2 Assessing business plan quality

The processes in this consultation are based on our proposals set out in 'Setting price controls for 2015-20 – framework and approach: a consultation' (our **'methodology consultation'**). Some details of these might change (such as the timetable or use of menus) depending on our final decisions following our review of responses to our methodology consultation.

Assessing business plan quality – preferred option for consultation

For each company, we assess the quality of each element in its business plan separately, allocating it to one of three processes:

- enhanced;
- standard; and
- resubmission.

The company receives an overall company category – enhanced, standard or resubmission – that determines procedural and financial rewards. The company category is determined by the lowest result of any single element and company-level checks such as financeability and affordability.

To create appropriate reputational incentives, we propose to publish the company category results early in the price review process.

We are also consulting on possible variations, such as only using enhanced and standard processes, and the timing of the announcements of the company categories.

Challenging companies' proposals – proposal for consultation

We create process incentives by tailoring our approach to scrutiny and challenge according to the quality of individual elements of business plans.

- Enhanced process elements are accepted in the round and are likely to be substantially unchanged for draft determinations.
- Standard process elements face more in-depth scrutiny, and some parts will be revised for draft determinations.
- Resubmission elements will need to be resubmitted, and will face the highest scrutiny – it is possible that this process may also cause other elements in a company's plan to be revised.

Setting price controls – proposal for consultation

We create financial and procedural incentives – to follow the reputational incentives described above – that depend on the overall category of a company.

- Enhanced category companies receive an **early draft determination**, as well as **additional financial incentives** – which may be in the form of an enhanced menu.
- For standard category companies, we publish draft baselines, and then draft determinations alongside final baselines.
- Companies in a resubmission category may **face a delayed draft determination**, and less attractive financial terms – which may be in the form of a menu that is less attractive than those used for the other categories, or Ofwat may set the incentive rate without using a menu.

2.1 Assessing business plan quality

For each company, we propose to carry out separate assessments for each element of its business plan (household retail, non-household retail, water wholesale and wastewater wholesale) to allocate each element to a process of:

- **enhanced** – for high-quality elements;
- **standard** – for elements that may fall short on some tests, but remain of a very good quality overall; and
- **resubmission** – for elements with serious shortcomings, or which lack the necessary information we need to complete our assessment, where we will require the company to resubmit the element (and other affected parts of the plan).

As well as allocating each element to one of these processes, the company would be assigned to **enhanced, standard or resubmission company categories**. These are determined by the lowest result from the assessment of the individual elements and (for enhanced and standard categories) company-level affordability and financeability checks. That is, a company with one element placed in a resubmission process would receive a **resubmission company category**.

Company categories would then determine the availability of some procedural and financial rewards.

- **Enhanced companies** are likely to receive early draft determinations, and qualify for additional financial incentives such as an enhanced menu with more attractive incentive rates.

- **Standard companies** would follow the standard process for setting price controls, and have access to standard incentives.

- **Resubmission companies** would face a delayed draft determination, and may face less attractive incentive rates in a menu, or Ofwat may set the incentive rate without using a menu

Our preferred approach is to determine company categories early in the process and publish the results for all companies. We consider this would create additional appropriate **reputational incentives** for high-quality business plans. We know that external stakeholders, including investors, highly value how Ofwat assesses companies, and so by being transparent about which companies fall into which categories, we expect to create strong reputational incentives for high-quality business plans. It may be the case that, after this early assessment, further information or evidence comes to light which suggests that a company should be downgraded and the relevant processes, procedures and available financial incentives changed. We would make a further announcement that this has happened.

Under our preferred proposal, we do not imagine a situation where further information would prompt us to upgrade a company's category later. This is because we expect all information we need to be included in high-quality plans from the outset. So missing or inadequate information in a plan may result in a lower category, and the later provision of more information would not lead to a revision of the category.

We are also considering the following options instead of, or in addition to, our preferred approach.

- **Elements earn procedural and financial rewards.** Rather than using the company category to determine the potential rewards, we could instead allow some elements with better assessments to attract some procedural, reputational and financial rewards.

- **Two-category approach.** Rather than using an explicit category of resubmission, we only clearly distinguish companies that have plans good enough to follow an enhanced process.

- **Two-process approach for retail.** Retail elements are likely to be less complex than wholesale. So it may simplify matters to use only enhanced and standard processes for retail elements.

- **Later decisions on resubmissions.** If we use the resubmission category, we could decide and announce later in the process that a plan needs to be resubmitted, rather than taking an early decision on them. So our early announcement would only say which companies have earned an enhanced category.

These options are not mutually exclusive and we could use combinations of each. We set out advantages and disadvantages of these possible approaches (compared with our preferred option) in table 2.

Table 2 Alternative approaches to assessing business plan quality

Option	Advantages	Disadvantages
Element results attract some procedural, reputational and financial rewards	Incentive rewards are easier to access and so potentially more attractive for companies	More complex overall process for setting price controls with different elements of the same company's plan potentially following different paths Reputational incentives may be dampened because the result for each company is not as clear
Two-category approach	Simpler process for assessing business plans	Fewer consequences for companies that submit poor plans – so weaker overall incentives for good plans
Two-process approach for retail business plans	Simpler process – reduces the number of variations of processes available Incentive rewards are easier to access and so potentially more attractive for companies	Potentially reduces incentives for good-quality retail elements
Later decisions on resubmission	More time for decisions means they are less likely to be revised downwards later	Less up-front certainty for companies and their stakeholders – this potentially dampens reputational incentives Less time for companies to resubmit plans, and for us to assess those resubmitted plans

2.2 Challenging companies' proposals

Once elements of a plan have been allocated to an enhanced, standard or resubmission process, we propose that our approach to scrutiny and challenge would be tailored – with better quality elements receiving lower levels of scrutiny.

This means that:

- companies with good plans benefit from a reduced burden, which incentivises high-quality plans; and
- regulatory resources are directed to challenging those areas where they are most likely to bring benefits to customers and the environment.

2.2.1 Challenging enhanced elements

We expect that elements that are rewarded by an enhanced process will be of a very high quality and very well evidenced. So, we think it is appropriate for enhanced elements to face a lower burden of scrutiny.

We propose that enhanced elements would be **accepted in the round**. This would mean that the company's proposals would be **substantially unchanged for this element in draft determinations**.

But if at any time, information or evidence suggests that the element is a lower quality than first assessed, the company category would be revised and the company would change track in the processes. We would make an announcement that this has happened and that the company's category has changed.

2.2.2 Challenging standard elements

Business plan elements that are placed in a standard process – while being acceptable as very good quality plans – will have fallen short on some tests. so we think it is appropriate that they face greater scrutiny in the form of a more in-depth review than enhanced elements.

In some cases, the company's business plan may contain all the information we need for any necessary revisions for draft determinations. In other cases, we may need to ask the company to provide additional information, explanation and justification so that we can take a decision on any appropriate changes.

If this process shows that the element needs to be changed significantly and resubmitted, the company category would be revised and the company would change track in the processes. We would make an announcement that this has happened and that the company's category has changed.

2.2.3 Challenging resubmission elements

We intend to put elements in the resubmission process if we identify serious shortcomings in a company's proposals such that, for this element, the plan should be returned to the company to be reworked. As such, we think it is appropriate that resubmission elements are subject to the most intensive scrutiny and challenge. For example, we may ask the company to provide additional evidence or justification to support its resubmitted element plan.

Depending on the quality of companies' resubmitted plans, we propose to base our draft determinations on an appropriate mix of companies' resubmitted proposals and our revisions of those proposals.

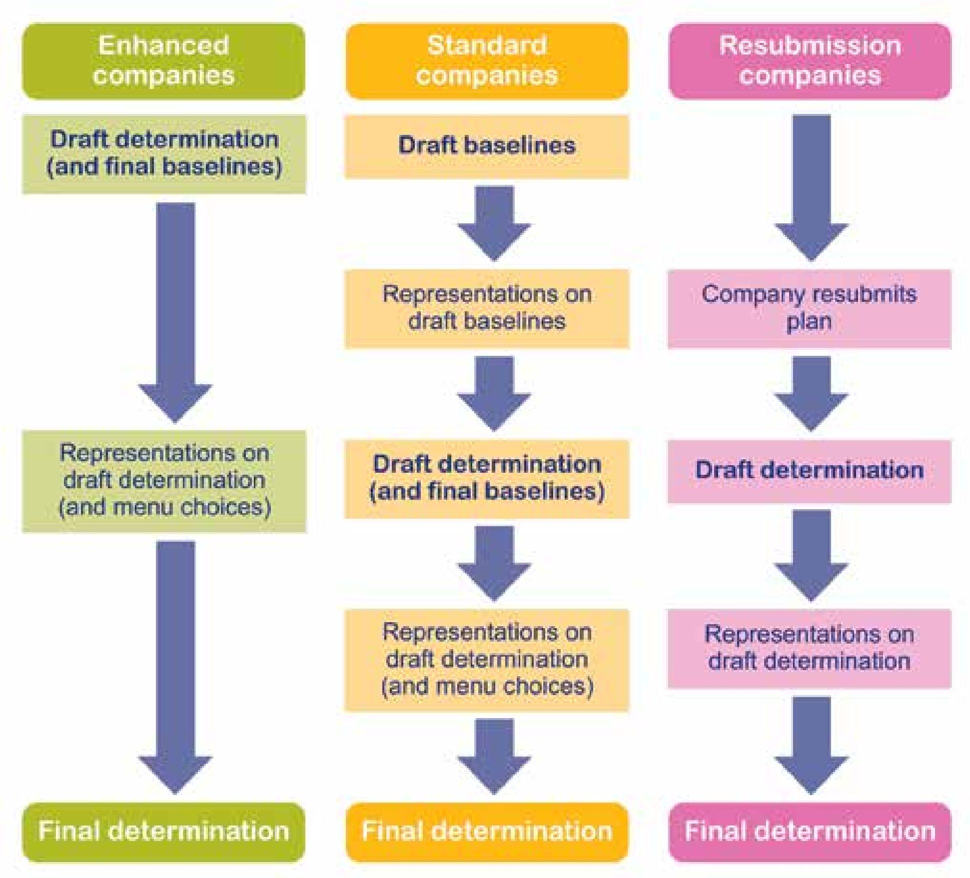
A resubmitted plan that then met our tests would not change the company's category – it would still remain as a resubmission company throughout the price review.

2.3 Setting controls

We propose to tailor the **process** we follow to set price controls in line with our **company-level categories** (see figure 3).

Our proposed process is based on the steps in the timetable we set out in our methodology consultation, and may be modified depending on our final policy decisions. It also shows a process where the rewards and less attractive financial terms are implemented through menus, but these could be allocated in a different way – they do not have to be allocated by the use of different menus for enhanced, standard and resubmission.

Figure 3 Overview of proposed process for setting price controls



We propose that **enhanced companies s**hould receive an early draft determination (including final baselines). They would then have the opportunity to make representations on the draft determination and their menu choice(s) ahead of final determinations.

For **standard companies**, we propose to first issue draft baseline(s) for consultation, followed by a formal draft determination (including final baselines) that will take into account representations from companies and customer challenge groups (CCGs). Companies would then be able to make representations on their draft determinations and menu choices ahead of final draft determinations.

We propose that any **resubmission company** would only receive a draft determination once we have assessed all elements of its plan, including the resubmitted elements. This is necessary because we cannot complete a draft determination until we have done the relevant company-level tests – for example, on affordability and financeability. And we will not be able to complete these tests if one or more elements of the plan may change substantially.

As with our approach to scrutinising and challenging business plans, tailoring the process for setting price controls, including creating greater early certainty for enhanced companies, should create strong **procedural incentives** for high-quality business plans.

We also propose to use **reputational and financial incentives** for high-quality plans.

A number of stakeholders, particularly investors, have told us that they put significant weight on Ofwat's assessment of companies when they themselves assess companies. So we consider that publishing the category results for each company will create strong reputational incentives by giving a clear signal to investors and other stakeholders to allow them to identify those companies that have – or do not have – high-quality plans, and can expect to benefit accordingly.

Our proposed process for setting price controls for companies with resubmission plans provides an opportunity to create financial incentives for high-quality plans. The delayed draft determination will make it more difficult for us to complete the steps needed for companies to make an effective menu choice. So, one option would be for Ofwat to set the incentive rate rather than allowing a company to position itself on a menu. Alternatively, we could offer a menu with incentive rates less attractive than for companies in enhanced or standard categories.

We also want to provide financial incentives for companies that achieve an enhanced category. We propose to do this by allowing companies with enhanced plans to choose from an enhanced cost performance menu, with more attractive incentive rates, or by allowing better financial terms through another mechanism.

The best approach to financial incentives will need to be consistent with our decisions on the use, design and calibration of menus and the overall incentive package. However we implement financial incentives, they should bring benefits to customers as well as companies. If we allow companies to retain a larger share of any outperformance, we would also expect customers to benefit in the longer term, as companies would have stronger incentives to deliver efficiency savings, which would be returned to customers over time.

2.4 Consultation questions

An incentives-based price review

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

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

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

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

3. The risk-based review in detail

Summary

In chapter 2, we explained that we are creating a suite of reputational, procedural and financial incentives for high-quality business plans. For these incentives to be effective, we need a robust approach to assessing business plan quality. This approach is our **risk-based review**.

For the risk-based review, we propose taking a staged approach (see figure 3) that looks at the following four key areas of companies' proposals for 2015-20.

- **Outcomes** – the company's key proposed deliverables, and the incentives associated with delivering them.
- **Costs** – the costs (for both wholesale and retail businesses) associated with delivering the company's proposed outcomes.
- **Risk and reward** – how the company's proposals balance risks, and the rewards for bearing those risks, between customers and the company (and its investors).
- **Affordability and financeability** – the impact of the company's proposals on customers' bills, and its ability to finance its functions.

We will also need to look at companies' **performance in 2010-15** – with a particular focus on how the outcome of the incentives from the last price review and any differences between actual and expected performance should be reflected in prices for 2015-20.

To be considered alongside the tests, we propose to require that the whole company Board – not just one or some executive member(s) – provide an assurance statement that the plans are of a high quality. This is a significant shift away from the more intrusive, and prescriptive, approach to assurance of previous price controls, and responds to a recommendation of the Gray review that we should take steps to **return ownership of the business plans to the companies**.

As part of this, and as part of the specific assurances we propose to require from Boards around outcomes, we expect them to demonstrate that companies are operating transparently and Boards are:

- providing adequate leadership to the company submitting the business plan; and
- complying with both the Financial Reporting Council's 'UK Corporate Governance Code' and relevant licence conditions.

Our approach to assessing companies' proposals for 2015-20 reflects the interdependencies between the different aspects of those proposals. For example, the efficient costs of delivery depend on what companies are proposing to deliver (that is, their outcome commitments). So it is not possible to assess costs without first assessing proposed outcomes. Similarly, our assessments of affordability and financeability depend on both the company's proposed costs, and its approach to risk and reward.

For each part of our assessment, we propose to test companies' business plans against a number of different **key assessment criteria**. In most cases, we propose to carry out separate tests for each element of the companies' plans. But there are some cases where we will also apply tests at a whole-company level.

We have considered carefully whether we should set out assessment thresholds in advance – and have decided not to do so. Setting out thresholds in advance would provide greater transparency to companies (and other stakeholders) about the process we will follow when assessing business plan quality – potentially reducing regulatory uncertainty.

But setting out precise (or even indicative) thresholds could also encourage companies to do no more than the minimum necessary to meet the assessment thresholds. This would reduce company ownership of business plans and undermine the incentives on them to produce the best possible plan. In turn, this could reduce our ability to secure a fair price review settlement for customers.

On balance, we think that the risks of revealing our assessment thresholds in advance outweigh the potential benefits.

Consequently, our preferred option is that **we do not set out our assessment thresholds in advance**. Nor do we intend to provide detailed information about our tests that might allow companies to 'second guess' them. This is in line with our aim of meeting the recommendations of the Gray review and returning ownership of the plans to companies' Boards – and to give us assurance they have accepted this ownership.

The risk-based review – proposal for consultation

We use tests that focus on the key areas of:

- outcomes;
- costs;
- risk and reward; and
- affordability and financeability.

We do not intend to set out the tests, or the detail of the thresholds for them, in advance.

We require assurances from companies' whole Boards that they have submitted a high-quality plan, and that companies are operating transparently and Boards are:

- showing good leadership to the company, and
- in compliance with both the Financial Reporting Council's 'UK Corporate Governance Code' and the relevant licence conditions.

3.1 Tests for outcomes

Our proposed tests for outcomes look at what companies are proposing to deliver for customers and the environment, including their proposed rewards for delivery and penalties for non-delivery. They cover three key areas related to the outcomes package:

- customer engagement;
- performance commitments; and
- outcome delivery incentives.

The CCGs' reports will provide us with important information about the quality of companies' customer engagement, and how well the companies' business plans reflect customer views and priorities. We expect them to form a key input to our risk-based review, and they could have a real impact on our assessment of companies' outcomes packages.

So we will need to have confidence in the CCGs' reports. We would expect to have this confidence if a CCG's report demonstrates:

- good evidence for its conclusions;
- evidence of thorough scrutiny of the customer engagement process;

- robust challenge of the company's proposed outcomes package and the extent to which it reflects the results of customer engagement; and
- a view that is independent from those of the company.

If we do not have confidence in a CCG's report, we will place less weight on its conclusions – whether those conclusions are supportive or critical about the company's business plan. We may also need to ask the company for more information to enable us to carry out our own assessment of its customer engagement and outcomes.

Table 3 Risk-based review tests for outcomes

Test	Key assessment criteria
Customer engagement	Has the company demonstrated an effective customer engagement process?
Performance commitments	Has the company given adequate assurance that its performance commitments are consistent with Defra's and (or) Welsh Government's Statement of Obligations, relevant statutory requirements and licence obligations, including in relation to serviceability? Are the company's proposed commitments consistent with: · requirements specified in our methodology, including in relation to SIM, AIM and leakage? · customers' preferences – as demonstrated through the company's customer engagement (taking into account other relevant factors)? · the company's track record of delivery in relevant areas? Do the company's proposed commitments reflect value for money, including the value customers place on different outcomes and other relevant factors? Are the company's proposed delivery measures appropriate and effective?
Outcome delivery incentives	Are the company's proposed delivery incentives appropriate to its performance commitments? Do the shape of the proposed incentives (for example, one-sided or two-sided) conform to the framework specified in our methodology? Do the proposed incentives represent an appropriate balance of risk between companies and customers?

3.2 Tests for costs

Our proposed tests look at the expenditure companies expect to incur delivering their proposed outcome commitments.

In line with our methodology consultation, we propose to carry out separate assessments of costs for each element of each company's business plan, which reflect the different nature of the price controls we are setting, and the different approaches we are taking to setting those controls:

- our proposed 'total expenditure' (totex) approach to setting wholesale controls for both water and wastewater;
- our proposed 'average cost to serve' (ACTS) approach to setting household retail controls; and
- our proposed 'default tariffs' approach to non-household retail controls.

So our proposed risk-based review tests include:

- a wholesale cost assessment – applied separately, but using the same key assessment criteria, to the water and wastewater costs; and
- separate assessments (using different criteria) for the household retail and non-household retail costs.

3.2.1 Wholesale costs

In our methodology consultation, we explained that we will use a range of analytical approaches to assessing wholesale costs, including advanced econometric models, and using historic, forecast and comparative cost information. From these approaches we might establish ranges ('cost corridors') or thresholds ('cost ceilings') to use as guides to appropriate costs.

These approaches and tests will inform our judgements on companies' proposed wholesale costs. Even if a company's wholesale costs fall outside the ranges established by our high-level cost guides, it will not necessarily fail the wholesale cost tests. Our decisions on whether to accept companies' proposals will depend on the quality of the evidence the company has provided to support its proposals.

In deciding what evidence to submit to support its proposals, and present a persuasive vision for the future, companies should note that clear, well-reasoned and appropriately targeted supporting evidence will be more likely to be effective than a large, unfocused submission.

Table 4 Risk-based review tests for wholesale costs

Test	Key assessment criteria
Wholesale cost assessment	Are the company's proposed costs consistent with the outputs of our cost assessment analysis? Has the company provided sufficient evidence and justification to explain its proposals?

3.2.2 Retail costs

As with our tests for wholesale costs, we will need to use a combination of cost analysis and judgement based on the overall plans, and explanations submitted by the companies, to reach a view on the appropriate level of retail costs for each company.

The precise approach we take to assessing retail costs will depend on our choice of approach to setting retail price controls – in particular our decisions, in the final methodology statement, on using:

- actual or forecast costs to set the household retail control; and
- companies' current costs, or our own assessment of notional costs, to set the non-household retail control.

But in broad terms, we expect our tests (see table 5 below) to enable us to:

- examine the **allocation of costs** between household and non-household retail – this will provide a light-touch check on the reasonableness of companies' non-household retail costs;
- carry out a more detailed assessment of companies' proposed **household retail costs**; and
- examine companies' proposed **non-household tariffs** and, also, compliance with any additional safeguards for Wales.

Table 5 Risk-based review tests for retail costs

Test	Key assessment criteria
Retail cost allocation	Has the company allocated costs appropriately between household and non-household retail?
Household retail cost assessment	For both proposed approaches, we expect to use the following criteria (ACTS will be defined by our methodology statement). · Is the company's proposed household retail cost to serve consistent with the industry ACTS (as adjusted to reflect the company's particular circumstances if appropriate)? · Has the company provided sufficient evidence to support any proposals for adjusting the industry ACTS to reflect its particular circumstances?
Non-household tariffs	Do the company's proposed tariffs recover no more than its allowed costs and margin? Do the company's proposed tariffs unduly discriminate between customers (or customer classes)?

3.3 Tests for risk and reward

In our methodology consultation, we explained that we planned to use a more extensive quantitative analysis to assessing risks than at previous price reviews; we are now providing more detail on our proposed approach.

We propose to collect a limited set of data to enable us to focus on using a scenario-based approach to assess companies' risk and reward packages. This should allow us to assess risks in a practical way for setting price controls, but only places a proportionate regulatory burden on companies.

We propose to use scenario analysis to assess the impact of risks on outcomes, costs and revenues – and therefore the impact on companies (for example, changes in the return on regulatory equity) and customers (for example, changes in service levels). There is a high interaction between these tests and the tests for company financeability (see section 3.4).

We will need to consider the impact of both:

- **common external risks** – which largely relate to the external environment although the impacts and mitigations vary from company to company. Examples might include changes in GDP, household growth and rainfall; and
- **company-specific risks** – which are company and (or) region specific and the nature of which (as well as the impacts) are therefore likely to vary across companies. An example might include the risk of project-specific cost over-runs.

Companies will need to prepare their business plans using consistent underlying assumptions for common external risks. Or they will need to explain clearly (including providing supporting evidence) if their assumptions are materially different. We will consider whether we should indicate, in our final business planning expectations document, which independent national forecasts (where relevant forecasts are available) companies should use as reference points for their base case submissions.

In assessing the impact of external risks, we are considering specifying in our final business planning expectations document scenarios that include specific 'upside' and (or) 'downside' variances relating to:

- household growth;
- industrial demand;
- input costs;
- the overall economic climate (combining common external risks to the above three inputs to business plans); and
- rainfall.

The companies are likely to be best placed to identify company-specific risks. As such, we will be asking them to provide the following additional scenarios for us to consider as part of our assessment of risk.

- A limited number of additional scenarios that reflect company-specific risks – if there are any such material company-specific risks (it is likely to be optional for companies to submit these additional scenarios but the number that we are able to take into account is likely to be limited).

- One scenario related to incentive performance, including the outcome delivery incentive package put forward by the company following customer engagement.

- Combined upside and downside scenarios that reflect their own chosen combinations of risk factors (including any relevant common external and company-specific risks) and incentive performance. These scenarios are designed to help us understand companies' views as to the envelope of the plausible upside and downside risks they face – and their potential impacts on customers and the company – in the context of their proposals for a financeable business plan.

Ofwat has a duty to ensure the financeability of efficient companies. Across all of the scenarios described above, for both external and specific risks, we therefore expect companies to include any actions they could take to mitigate the identified risks (and in setting out evidence to support their modelling, we ask that they set out clearly which assumptions about mitigation have been included; and why they would not expect to take any further mitigation steps).

We welcome views from stakeholders on our proposed approach to analysing risk in response to this consultation. We will also continue to engage with stakeholders as we develop our approach.

Our proposed tests for risk and reward (see table 6) look at each company's overall package of risks and rewards for each element of its business plan, and for the company as a whole. In particular, we will need to consider:

- overall levels of risk;
- the allocation of risk between customers and shareholders; and
- whether the returns assumed in the company's business plan are appropriate for the risks it is bearing.

Table 6 Risk-based review tests for risk and reward

Test	Assessment criteria
Risk analysis	Has the company provided sufficient information – including on company-specific risks – for us to analyse the impact of risks on customers and companies? Are the company's proposed risk impacts within plausible and acceptable ranges?
Level and allocation of risk	Do the different commitments and incentives within price control elements of the business plan involve an efficient level and allocation of risk? In deriving these proposed allocations, has the company made appropriate assumptions in relation to the mitigation of risk?
Rewards and returns	Do the returns assumed in the company's business plan provide rewards to the company (and its investors) that are appropriate to the relevant risks the company is bearing for each element of its plan?

3.4 Tests for affordability and financeability

In setting price controls, we need to achieve a careful balance between ensuring that our proposals are affordable to customers, and also allowing efficient companies to raise finance on reasonable terms.

Companies' proposed approach to cost recovery in wholesale controls will be particularly relevant to assessments of both financeability and affordability as they will affect its proposed pricing levels. So we may review and compare companies' proposed:

- PAYG ratios (which govern how current and future customers share the costs of long-term investment); and
- approaches to allocating and depreciating their regulatory capital value (which govern the long-term returns on investments).

These are relevant to both affordability and financeability tests.

3.4.1 Affordability

Our main tests for affordability (see table 7) focus on the impact on customers' bills over time, including beyond 2015-20. In making our assessments of affordability, we will also need to consider:

- any tools available to customers to mitigate bill impacts (such as metering and social tariffs for vulnerable customers); and
- the extent to which bill impacts are common at an industry level or specific to individual companies.

Table 7 Risk-based review tests for affordability

Test	Key assessment criteria
Affordability	Are the company's proposals affordable over 2015-20? Are the company's proposals affordable in the longer term? And has the company demonstrated that it has explored all possible options to ensure that this is the case, for example, by the way it has set out its cost recovery proposals?

3.4.2 Financeability

In line with the approach we have taken at previous price reviews, our main test for financeability (see table 8) focuses on the company as a whole. But, to reflect the introduction of separate binding controls, we also propose to carry out checks that look at individual controls on a stand-alone basis – with a particular focus on whether undesirable cross-subsidies may exist and if so, whether the company has presented adequate plans to address these.

Key factors we will need to consider in making our assessments include:

- the risks the company faces, the remuneration assumed for those risks, and the financing assumed consistent with such remuneration;
- the financial indicators the company is using to assess its financeability, including how they relate to the company's proposed credit rating and the price limits assumed in the company's business plan; and
- the sensitivity of these indicators to companies' proposed key risk drivers (including relevant company-specific risk drivers), by looking at the impact of relevant scenarios (described in section 3.3) on the company's financial performance.

Table 8 Risk-based review tests for financeability

Test	Key assessment criteria
Overall financeability	Taking account of assumptions on costs, revenues, risks, and capital structures, will the company be able to sustain a comfortable investment grade credit rating? Do the company's proposals represent a fair balance between the company, current and future customers?
Financeability of individual controls	Do the company's proposals for each control allow sufficient returns to be self-financing over the longer term?

3.5 Performance in 2010-15

In our methodology consultation, we confirmed our commitment to reconciling the regulatory tools and incentives employed during the 2010-15 period, and adjusting price controls for 2015-20 to reflect differences between actual and forecast performance between 2010 and 2015. The key aspects of performance we will need to reconcile are:

- customer service performance – using the service incentive mechanism (SIM);
- revenues – using the revenue correction mechanism (RCM);
- material differences between actual and projected delivery – including both changes in the number of outputs delivered (logging up and down) and any failures to deliver funded outputs (shortfalls);
- operating expenditure – to determine whether companies qualify for an opex incentive allowance (the 'opex roller'); and
- capital expenditure – using the capital expenditure incentive scheme (CIS).

We will also need to consider the impact of land sales, changes in financial structures, and – for some companies – whether companies raised new equity in line with the assumptions we made at the 2009 price review.

Taken together, these may involve substantial amounts of revenue and expenditure – and can have material impacts on customer bills in 2015-20. There are also interactions between different reconciliations – in particular, differences in delivery affect reconciliations of both operating and capital expenditure.

Consequently, we need to make sure our approach to reconciling performance in 2010-15 enables us to protect the interests of customers, without placing a disproportionate burden on companies.

In line with our more general approach to business planning, we propose to place the onus on companies to present truthful and complete information in their business plans on both:

- the differences between actual and expected performance in 2010-15; and
- the adjustments that should be made to 2015-20 price controls to reflect those differences.

We will use our risk-based review tests (see table 9) to identify outliers, inconsistencies and other areas of concern, and to inform our decisions on the appropriate adjustments to companies' price controls for 2015-20. Boards' assurance statements for the business plan should, of course, cover this area given the potential impact on customers' bills.

Table 9 Risk-based review tests for performance in 2015-20

Test	Assessment criteria
Actual performance	Has the company fairly reflected its performance in 2010-15? Is the company's reported performance consistent with: · its risk and compliance statements and published key indicators? · other companies' reported performance (where relevant)?
Adjustments to 2015-20 price controls	Has the company calculated any adjustments to 2015-20 price controls in line with our guidance (for example, for CIS and RCM)? Do the company's proposed adjustments to 2015-20 price controls fairly reflect its performance in 2010-15?

In line with our general approach to scrutiny and challenge of companies' proposals, where a company falls into standard or resubmission categories we may – where appropriate – require further information or assurance on this area of companies' proposals.

3.6 Board business plan assurance

For previous price reviews, we have required companies to submit independent reports and commentary assuring each line of their business plans. This approach led to assurance that was poorly targeted, and increased significantly both the regulatory burden and cost of the price review.

We want each company's Board to own and be accountable for the business plan it submits for the 2014 price review. This is consistent with our wider policy set out in 'Delivering proportionate and targeted regulation – Ofwat's risk-based approach' (our 'regulatory compliance document') and the Gray review.

Consequently, we do not intend to prescribe (or provide detailed guidance on) the approach companies should take to business plan assurance. Instead, we expect companies' whole Boards – the whole board, not just one or some executive member(s) – to sign off business plans. We also expect them to put in place any processes that they feel they need to be assured that they are submitting high-quality plans – as any commercial company would expect to do in other regulated and unregulated sectors.

Boards then need to give us a statement, in their own words, of why they consider that all the elements (and supporting data) add up to a business plan that is high quality, and that estimates and data have been arrived at appropriately, and independently of other companies and competitors.

By **high-quality business plan** we mean a plan that:

- is designed to deliver good outcomes for customers and the environment and ensures companies meet their statutory obligations;
- contains accurate and efficient projections and estimates without inflated costs;
- is not a 'bid' and does not seek to game the regulatory process; and
- contains fair proposals to share 'pain and gain' with customers.

In preparing their statement, Boards should also cover the specific assurances required around outcomes (see section 3.1) and performance in 2010-15 (see section 3.5) and also explain how the Board and company are operating:

- transparently;
- with good Board leadership guiding the company; and
- in compliance with both the Financial Reporting Council's 'UK Corporate Governance Code' and the relevant licence conditions.

We will take these factors into account, in assessing business plans, and placing companies into categories, alongside how strong an assurance Boards feel able to give that their plans are high-quality plans. Of course, nothing in our decisions in the risk-based review would reduce the likelihood of future investigation possibly leading to enforcement action that we, or other regulators, might do if a company is suspected of being in breach of a statutory obligation.

As we explained in section 3.5, later in the price setting process, we may also require further assurance in relation to the information companies submit on their performance in 2010-15.

3.7 Consultation questions

The risk-based review in detail

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

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

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

4. Delivering focused information requirements

Summary

We want to step back from the detailed and prescriptive business planning guidance we have issued for previous price reviews. Instead, we want to focus on the key information and data we will need to set price controls. This should help us deliver a targeted and proportionate price setting process, in line with the principles set out in our regulatory compliance document and our future price limits principle of **'proportionate price setting'**.

So, we propose that companies should provide an overall **business plan narrative** that explains their proposals for 2015-20, and how they arrived at them. It will be for companies' Boards to determine the best way to present their proposals – we do not want to constrain companies' approaches by issuing prescriptive guidance or templates that companies should follow.

Of course, it will be important that business plans and the narrative provide a persuasive vision for the future which is supported by compelling evidence. A company that submits clear, well-reasoned evidence – which is in a form accessible to us, customers, CCGs, and other regulators and stakeholders – will be more likely to have its proposals accepted than a company that does not.

We will need a consistent set of information and data so that we can set price controls. In setting out the data that we intend to collect, we have been careful to make sure that we specify the right amount of data – which is all the data we need to set price controls, but not more than we need. We have reviewed our proposed requests carefully against the processes and analysis that we expect to carry out. This document sets out **why** we need the data we are proposing to request.

The risk-based review set out in chapter 3 is a key part of delivering a more proportionate and targeted price setting process. Companies with high-quality plans (which qualify for enhanced assessments) can expect a reduced data burden compared with previous price reviews. But we may need to require additional information and data from companies with poorer quality plans.

We propose that companies should provide a common set of **supporting data tables** and associated commentaries alongside their business plan narratives.

We are also asking companies' CCGs to submit their reports alongside business plans. **CCG reports** will provide us with important information about the quality of companies' customer engagement, and how well the business plans reflect customer views and priorities. They will form a key input to our risk-based review.

To help us update, test and refine our cost assessment tools ahead of business plans – better accuracy of the models will help the processes run more smoothly to the benefit of both Ofwat and companies – we will be collecting a limited amount of cost data for 2010-15 in August 2013 (the **'August submission'**). All of the data we request for this submission should be straightforward to collect. We will also ask companies to include information on their SIM performance up to 2012-13 in this submission.

We are not consulting on the August submission, in the same way as the rest of the proposals in this document, so companies should prepare now to respond to this request. We will, however, consider any comments received by 23 May 2013. We will then issue our final information request to companies soon after.

As we explained in chapter 3, we are also making changes to our approach to **assurance** of companies' business plans – with company Boards signing them off and taking responsibility for determining the processes they need in order to do this.

Delivering focused information requirements – confirmed direction
We will request a small, focused data submission in August 2013 to enable us to refine our cost assessment tools and assess SIM performance. **Company Boards are responsible for signing off the august data submission, and determining the processes they need to do this.**
Delivering focused information requirements – proposal for consultation
Business plans should include a business plan narrative that explains the company's proposals – we do not intend to specify the form or content of this narrative. **Business plans for 2015-20 should also include supporting data tables – the content of which we are now consulting on.** **Company Boards are responsible for signing off the business plans, including the supporting data tables, and determining the processes they need to do this.**

4.1 The business plan narrative

The purpose of a company's business plan narrative is to allow it to explain its proposals for 2015-20, and how it arrived at them. In line with our overall approach to business planning, we want company Boards to own, and be accountable for, their business plan narratives.

So, we do not propose to set out a prescriptive template for, or provide detailed guidance on, the business plan narrative. We expect each company's proposals to be different, and to take account of its own customers' priorities and its particular circumstances. We want companies to be free to tell the story of their business plan in way that reflects these differences, rather than be constrained by a regulatory template.

But we would expect companies' business plan narratives to provide a full picture of their proposals, covering the following four key areas we will assess in the risk-based review.

- **Outcomes** – what the company is proposing to deliver for its customers and the environment, including how:
  - it has engaged with customers in developing its proposals – and how those proposals reflect customer views and priorities;
  - its proposals deliver the best long-term, sustainable solution for customers and the environment;
  - its proposals include appropriate incentives to secure delivery and value for money for customers; and
  - it has, and intends, to meet its statutory obligations.

- **Costs** – the company's proposed costs for delivering its outcome commitments, including how these proposals reflect the efficient cost of delivery.

- **Risk and reward** – the company's approach to risk and reward, including how it has determined:
  - an efficient distribution of risk between customers and the company; and
  - returns that provide appropriate rewards for the level of risk it is bearing.

- **Affordability and financeability** – the impact of its proposals on customers' bills, and on the company (and its investors). We would expect this to include discussion of the companies' approach to financing long-term investment.

We expect companies to set out their proposals separately for each price control, as well as for the company as a whole where necessary – for example, for affordability and financeability. It may also be the case that particular aspects of a company's plan have significant impacts on customers' bills, for example because of performance in 2010-15 or future investment plans – and Boards should cover these areas in detail in their narratives.

The business plan and the narrative should be designed to be accessible to us, to customers, to CCGs, and to other regulators and stakeholders.

We will also expect the business plan narrative to contain the assurance from the Board as explained in section 3.6.

4.2 Supporting data tables

Companies' business plan narratives will provide us, and customers and other stakeholders, with a broad overview of companies' proposals for 2015-20. But to fully assess their business plans, carry out our risk-based review and set price controls, we will also need some consistent, specific data. We propose to collect this information alongside business plan narratives, using our supporting data tables.

Although still subject to consultation, and our final methodology, the data we think we need for the early stages of the risk-based review is a substantial reduction on that asked for in previous reviews. So companies with very high-quality plans, which qualify for enhanced category, can expect a reduced data burden compared with previous price reviews. But we may need to require additional information and data from companies with poorer quality plans.

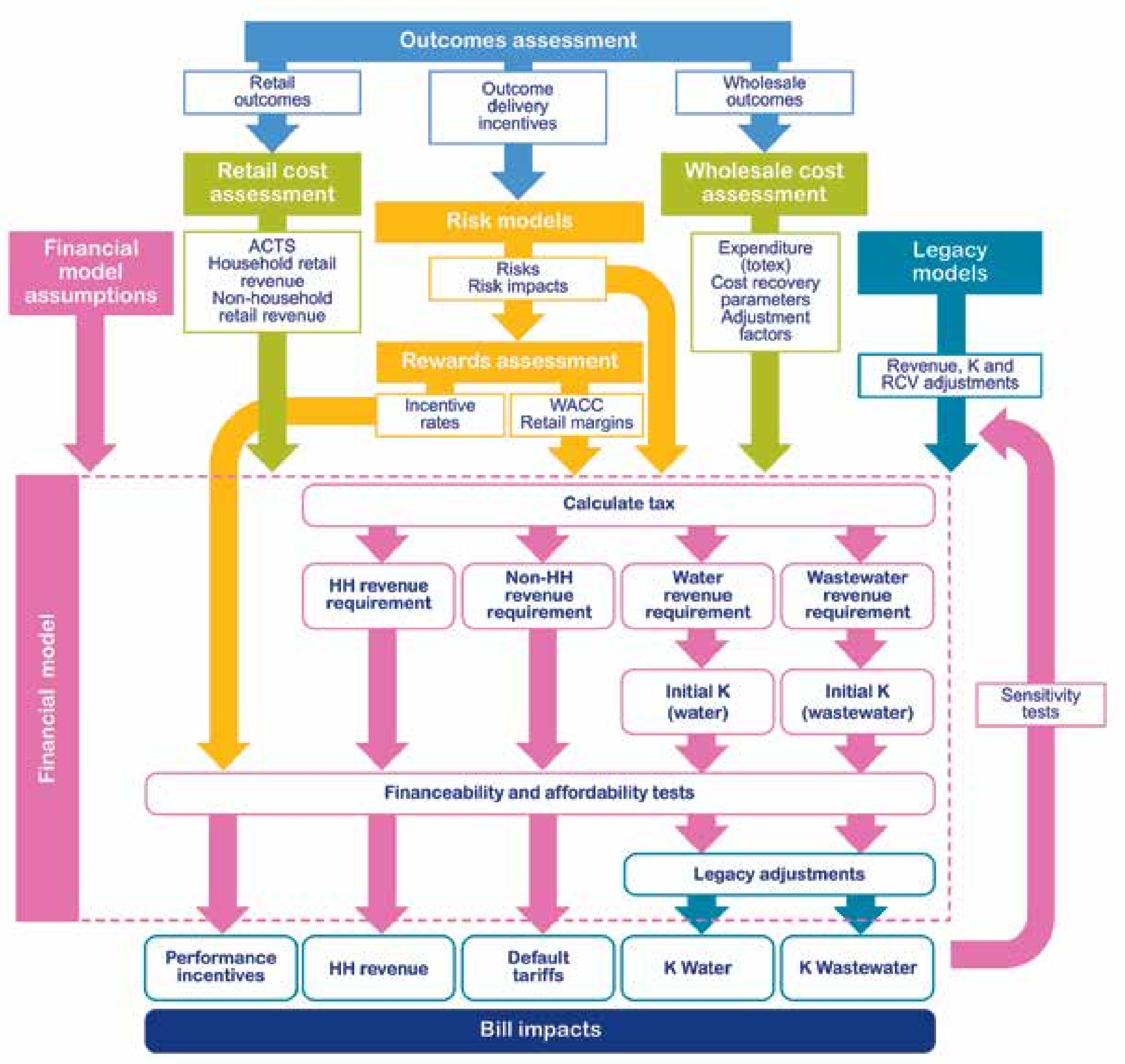
To explain the information we need companies to provide, it is helpful to first explain the analysis we intend to use to set price controls and support our assessments of companies' business plans.

The principal tool we propose using is a financial model, which we will use to:

- set price controls based on companies' outcomes, costs and revenues;
- calculate tax, and assess the financeability of individual controls, as well as the price control package as a whole;
- help to assess potential risk using scenarios; and
- make adjustments to reflect performance in 2010-15.

We will collect some of the inputs used by this financial model directly. But we will also be using a number of other processes and assessments to help us determine the rest of the inputs we need. We illustrate the relationships between the financial model and various processes and assessments in figure 4.

Figure 4 Our proposed approach to analysis



The analysis illustrated above includes a number of components or stages.

- The **outcomes assessment** includes an assessment of both the company's outcomes, and their associated delivery incentives.

- The **retail cost assessment** determines the ACTS (and associated household retail revenue) and non-household revenue.

- The **wholesale cost assessment** includes:
  - water cost assessment;
  - wastewater cost assessment;
  - additional wastewater cost assessment – for example, for large sewage treatment works;
  - a separate assessment of any other costs excluded from our main cost assessment models; and
  - our assessment of the company's proposed approach to cost recovery and its proposed adjustment factors for the wholesale controls.

- The **risk analysis** will use scenarios to assess levels of risk.

- The **rewards assessment** includes our assessments of incentive rates, the weighted average cost of capital and retail margins.

- The **legacy assessment** will determine adjustments needed to reflect performance in 2010-15, and include:
  - our assessment of SIM rewards and penalties;
  - the CIS true-up model;
  - our assessment for the opex incentive allowance ('opex roller');
  - the RCM true-up model; and
  - our assessment of adjustments to the RCV, and of any clawback of costs for issuing new equity or tax benefits of changes in financial structures.

- The **financial model assumptions** include accounting and financing data we will need to run the financial model and calculate tax.

We have set out the data that we need to run this analysis in the template supporting data tables grouped by the different price controls we intend to set for 2015-20 shown at the bottom of figure 4.

We propose that companies should provide four sets of supporting data tables – one each for:

- water wholesale;
- wastewater wholesale;
- retail (including both household and non-household); and.
- the whole company (the appointed business).

For each set of supporting data tables, we summarise the information that we expect companies to provide – and how we intend to use it – below.

Table 10 Supporting data tables (water wholesale)

Data table	Contents	Needed for
W1	Outcomes, performance measures, and associated expenditure	Outcomes assessment
W2	Proposed outcome delivery incentives, costs and benefits	
W3 and W4	Information on wholesale costs and cost drivers (to set our baseline)	Wholesale cost assessment (main costs assessment model)
W5	Information on asset values	Wholesale cost assessment (cross-check on main models)
W6	Information on demand, connections, and metering	Input to cost, risk, financial models
W7	Historic abstractions above the abstraction incentive mechanism (AIM) threshold	Rewards assessment (setting incentive rates)
W8	Breakdown of demand by non-household group	Input to cost, risk and financial models
W9	Wholesale forecast revenues	Financial model assumptions
W10	Cost recovery rates	Wholesale cost assessment (cost recovery)
W11	Proposed costs excluded from cost assessment and menus	Wholesale cost assessment (excluded costs)
W12	Adjustment factors for the wholesale form of control	Wholesale cost assessment (setting adjustment factors)

W13	Logging up and logging down claims (from the period 2010-15)	Legacy models (both CIS true-up and opex incentive allowance)
W14	Costs associated with overlap programme	
W15	Information to calculate capital expenditure incentive scheme (CIS) adjustments (this model is published on our website)	Legacy models (CIS true-up)
W16	Information to calculate the operating expenditure (opex) roller adjustments	Legacy models (opex incentive allowance)
W17	Information for the revenue correction mechanism information (this model is published on our website)	Legacy models (RCM true-up)
W18	Weighted average cost of capital	Rewards assessment (WACC)
W19	Wholesale returns	Financial model assumptions

Table 11 Supporting data tables (wastewater wholesale)

Data table	Contents	Needed for
S1	Outcomes, performance measures, and associated expenditure	Outcomes assessment
S2	Proposed outcome delivery incentives, costs and benefits	
S3 and S4	Information on wholesale costs and cost drivers (to set out baseline)	Wholesale cost assessment (modelling wholesale costs)
S5	Information on asset values	Wholesale cost assessment (cross-check on main models)
S6	Information on transferred private sewers (to set our baseline)	Wholesale cost assessment (private sewers)
S7	Information on large sewage treatment works (to set our baseline)	Wholesale cost assessment (large sewage treatment works)
S8	Breakdown of demand by non-household group	Cross-check for wholesale cost assessment
S9	Wholesale forecast revenues	Financial model assumptions

S10	Cost recovery	Wholesale cost assessment (cost recovery)
S11	Proposed costs excluded from cost assessment and menus	Wholesale cost assessment (excluded costs)
S12	[Not used]	
S13	Logging up and logging down claims (from the period 2010-15)	Legacy models (both CIS true-up and opex incentive allowance)
S14	Costs associated with the overlap programme	
S15	Information to calculate CIS adjustments (this model is published on our website)	Legacy models (CIS true-up)
S16	Information to calculate the opex roller adjustments	Legacy models (opex incentive allowance)
S17	Information for the revenue correction mechanism (this model is published on our website)	Legacy models (RCM true-up)
S18	Weighted average cost of capital	Rewards assessment (WACC)
S19	Wholesale returns	Financial model assumptions

Table 12 Supporting data tables (retail)

Data table	Contents	Needed for
R1	Outcomes, performance measures, and associated expenditure for household customers	Outcomes assessment
R2	Proposed outcome delivery incentives, costs and benefits for household customers	
R3	Information needed to set the household average cost to serve (ACTS) control	Retail cost assessment (household)
R4	Information needed to set non-household default tariffs	Retail cost assessment (non-household)
R5	Retail margins for households and non-households	Rewards assessment (retail margins)

Table 13 Supporting data tables (appointed business)

Data table	Contents	Needed for
A1	Price limits and average bills	Comparison with bill impacts
A2	Wholesale financing and debt	Financial model assumptions (financing and tax)
A3	Wholesale tax	
A4	Network management and network plus	Wholesale cost assessment (excluded costs)
A5	Defined benefit pensions	
A6	Drinking water quality and environmental obligations	Wholesale cost assessment (cross-checks on main cost models)
A7	Adjustments to RCV from disposals of land	Legacy models (RCV true-up)
A8	Financial ratios	Financial model assumptions (financing)
A9	Inflation measures	Input to cost, risk, legacy and financial models
A10	Income statement	Financial model assumptions (accounting information)
A11	Balance sheet	
A12	Trade receivables	
A13	Other working capital assumptions	
A14	Cash flow statement	
A15	Fixed assets	
A16	Fixed assets – operating costs	
A179	Off balance sheet debt	
A18	Grants and contributions	
A19	Operating profit and dividends analysis	
A20	Scenarios	Risk models

4.3 The August submission

In our methodology consultation, we explained that we are developing a suite of cost assessment tools (including advanced econometric models), which we are proposing to use to:

- assess companies' costs for the risk-based review; and
- determine cost assumptions we will use to set wholesale and retail controls.

We want our cost assessment tools to be as robust as possible. The more robust our models, the more reliably they will help us to identify appropriate levels of expenditure. This will benefit both companies and customers, by allowing us to make better judgements on costs, and to focus our challenge to companies' cost proposals where it is really needed.

So we want to carry out further work updating, testing and refining our cost assessment tools before companies' submit their business plans. To do this work, we plan to collect a limited amount of **cost information** from companies in August 2013.

Alongside this, we also need to collect some information on companies' **customer service** performance.

The assurance process for the August submission is the same as for the business plan as a whole – with Board sign off. So company Boards are responsible for determining the assurance they need to confirm the accuracy and completeness of the August data submission. Data required for cost assessment is critical to the overall result of the price review and it would be proportionate for the strength of the assurance processes that Boards decide on to be proportionate to this.

4.3.1 Cost information

The cost information we are proposing to collect, which is set out in full in appendix A1.5 covers:

- wholesale water and wastewater costs;
- costs resulting from the transfer of private sewers to their ownership in October 2011; and
- costs for large sewage treatment works.

To ensure we can develop our tools fully, we are asking companies to submit both historic and, in some areas, forecast cost data for the period 2010-15.

Historic data should be consistent with information companies have submitted as part of their published regulatory accounts. For forecast data, we expect companies to draw on available management information for 2013-15. We do not expect them to provide us with any data related to their 2015-20 costs.

In both cases, we consider that companies should be able to readily provide the cost information we are asking for.

Companies will not need to resubmit information they provide in their August submission in their business plans, but they may choose to do so.

Later in the price review, around summer 2014, we may ask companies to provide updated cost and performance information that reflects their actual 2013-14 experience. This will inform the adjustments we will make to our final determinations to reconcile companies' performance against the tools and incentives employed during the 2010-15 period. We might also need to collect some information on companies' retail costs for 2013-14 to inform our final determinations.

4.3.2 Customer service information

When we set prices in 2009 we included an incentive – the service incentive mechanism (SIM) – to reward good customer service performance during 2010-15.

In our methodology consultation, we confirmed that we would use the SIM to assess companies' customer service performance during 2010-15 and, where appropriate, make an adjustment to their price controls for 2015-20 based on that performance.

For draft determinations we will only be able to take account of companies' performance in 2011-12 and 2012-13, and we will collect the information we need in the August data submission.

For final determinations, we will need to we will need to take account of companies' performance in 2013-14, and will ask for this information later in the price review – probably in summer 2014.

4.4 Customer challenge group reports

The CCG reports will be an important input to our risk-based review. We expect good quality CCG reports (whether they are supportive or critical of a company's engagement with its customers) to strongly influence our risk-based review of companies' proposed outcomes packages.

If we do not have confidence in a CCG's report, we would place less weight on it. But if this were the case, it would not be appropriate for us to automatically conclude that the company's customer engagement was inadequate.

So, we would need to directly take a view on the quality of its customer engagement from the company's business plan. If we are satisfied that the company's customer engagement has been adequate, and is appropriately reflected in its proposed outcomes package, then it would not fail the relevant risk-based review test.

We are asking CCGs to provide us with their reports alongside companies' business plan submissions. This is because our risk-based review begins with an assessment of a company's customer engagement process. We expect companies to ensure that CCGs have sufficient sight of their final plans, including any late, material changes, to submit their reports alongside business plan submissions.

Given the diverse nature of the companies and their customer engagement, we do not think it would be helpful to prescribe a format, or issue a set template, for CCGs' reports. We want to promote innovative approaches from companies and CCGs, and do not want CCGs to constrain their challenge and reporting to a standardised approach prescribed by us.

Building on existing engagement, we will continue to work with CCGs throughout the price review process so that they:

- are well prepared to produce reports that effectively support our review of business plans; and
- can also engage effectively with companies following publication of draft baselines and draft determinations.

As part of this engagement, we plan to hold a workshop with CCG chairs and water companies alongside this consultation.

4.5 Consultation questions

Delivering focused information requirements

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

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

5. Application to small companies

5.1 Overview

The ten water and sewerage companies, and the eight largest water-only companies, have provided water and sewerage services to the vast majority of customers in England and Wales since privatisation. The smallest of these 18 **'incumbent companies'** has about 120,000 customers.

The remaining customers in England and Wales receive their supplies from what we call the **'small companies'**:

- Cholderton & District Water – the only other incumbent water only company, which has about 700 customers; or
- one of the five **'new appointees'** – companies that started providing water and sewerage services to customers after privatisation. They mostly serve specific geographic areas within the supply areas of the incumbent companies, focusing on providing retail services and the last elements of the supply network, such as supply pipe services. But they can also compete to serve large non-household customers. The largest of the new appointees currently has about 2,000 customers.

These small companies have the same legal duties and responsibilities as the large incumbent companies, and we have the same statutory duties to ensure that they can finance their functions and to protect their customers.

We also need to take account of the legislative changes proposed by the UK Government in its Draft Water Bill, which would allow all non-household customers served by small companies in England to choose who provides their retail service. This is one of the reasons we confirmed our intention to set separate wholesale and retail controls for the 18 largest incumbent companies in our methodology consultation.

But the small companies are also all significantly smaller than the 18 largest incumbent companies, and we estimate that they serve only about 200 non-household customers between them. So, in line with our future price limits principle of **'proportionate price setting'**, we propose to reflect this difference in the approach we take to both **setting price controls** and **business planning** for small companies.

In particular, we propose that we should not set separate wholesale and retail price controls for small companies at this stage.

Application to small companies – preferred options for consultation

For all small companies we propose to:

- set a single price control, rather than separate wholesale and retail controls;
- develop our approach to setting price controls outside the process set out for the large incumbent companies; and
- consider whether to develop a small company service incentive.

For new appointees we propose to continue setting a relative price control.

For Cholderton & District Water we propose to:

- continue setting a simplified control; and
- adopt a simplified process for setting its control, including a simpler business plan and different risk-based review.

5.2 New appointees

New appointees are currently the most successful route for entry into the water industry. They provide an element of competitive challenge to the incumbent companies, and benefits to customers, such as price discounts and enhanced service levels.

But in most cases, they only provide competition for the market rather than the sort of competitive pressure that provides strong, on-going protection for customers. Once a new appointee is providing a service it is a monopoly provider like the rest of the companies we regulate. So where this is the case, we need to consider the best approach to regulating the **prices** they charge and the **service** they provide.

5.2.1 Regulating prices

In the past, we have not set individual price limits for new appointees when they have become a monopoly provider for an area. Instead, we have set relative charge controls, so that each element of the new appointees' tariffs are fixed relative to (and cannot exceed) the equivalent end tariffs charged by the incumbent company in whose area they operate. If the incumbent offers specific tariffs to particular groups, such as vulnerable customers, we have expected the new appointee to offer the equivalent tariffs as well.

We consider that these arrangements have provided effective, transparent and proportionate regulation of new appointees' prices. Given the success of these arrangements, and the current size of the new appointees, we propose to continue with our existing approach to price setting for new appointees.

5.2.2 Regulating service

We have also taken a proportionate approach to regulating the service that new appointees provide. All new appointees – like all other water and sewerage and water only companies – are subject to the Guaranteed Standards Scheme (GSS) that provides for minimum service standards across a range of areas. New appointees are also required to ensure that the level of service they provide is no worse than that of the incumbent company.

We want to ensure that all customers have adequate and proportionate protection over the level of service they receive – especially where they have no ability to choose their service provider. So we are considering whether a service incentive specifically for small water companies is required.

We have considered extending the SIM to all small companies, including the new appointees. But we do not think this would be appropriate or proportionate approach at this time. This is because the small companies only serve a limited number of customers – making it difficult to produce the reliable customer survey results that form part of the SIM. We also think that the relative cost of carrying out the surveys and collecting other data required to operate the incentives would be disproportionate given the size of the companies and the number of customers they serve.

5.3 Cholderton & District Water

Cholderton & District Water is an incumbent water company, and – to ensure we have been appropriately protecting its customers and fulfilling our duties – we have set a price control for it at every previous price review.

But we have also taken account of the company's very small size in setting its price controls, using a much simpler price review process than for other, larger incumbent suppliers.

We propose to continue with this approach to setting price controls for Cholderton & District Water, by:

- setting it a simplified price control;
- requiring it to submit a simplified business plan that is less extensive than that set out in this consultation for the other incumbent companies; and
- not subjecting its business plan to the same risk-based review we propose in this consultation.

The company is not currently subject to the SIM we apply to the other incumbent companies. We have not applied it because we did not consider it a proportionate approach. This is consistent with our views on applying SIM to new appointees.

If we decide to develop a specific service incentive for small companies, we will apply it to Cholderton & District Water as well as new appointees. This will ensure that customers of all small water companies receive the same service protection.

5.4 Consultation questions

Application to small companies

Q10 Do you agree with our proposal to continue to set price limits for new appointees using a relative price control? If not, what alternative do you prefer?

Q11 Do you agree that we should set Cholderton & District Water its own simplified price control?

Q12 Do you think that we should develop a new small company service incentive? If so, what form do you think this incentive should take?

Q13 Do you agree with our proposal that small water companies should not be subject to separate wholesale and retail price limits?

Q14 New appointees are growing in size. In the future do you think that we might need to adopt a different approach to regulating their prices and service? If so, what circumstances should prompt a change of approach?

6. Next steps

6.1 Business planning expectations

In our methodology consultation, we explained that there are three main phases of work we need to complete to deliver price controls in 2014. These are to:

- develop our final methodology;
- develop our business planning expectations; and
- deliver our determinations – assessing companies' business plans and setting draft and final determinations.

This consultation closes on 23 may 2013. It is the first step towards delivering that second phase of work. We will use responses to this consultation to inform our decisions on our final business planning expectations, which we expect to publish in summer 2013.

In taking our decisions on our final business planning expectations, we will also need to take account of any changes to our proposed approach to setting price controls for 2015-20. We will set these out in our final methodology statement, which we expect to publish in early summer 2013.

We are continuing our programme of engagement over our approach to setting price controls for 2015-20 during the consultation period. This includes stakeholder workshops covering key issues raised in this consultation. We will take account of all stakeholder feedback, including from these workshops, in our decisions on our final business planning expectations.

6.2 Timetable for setting price controls

In our methodology consultation, we explained that implementing effective menu regulation for wholesale price controls creates a tightly-constrained timetable for delivering price controls in 2014.

Implementing menus effectively could create significant benefits for both companies (which would receive greater control over their allowed wholesale costs – and associated cost incentives) and customers (as it encourages companies to present their best possible cost forecasts). Our preferred option remains to use menus for wholesale controls, and we continue to work with stakeholders to agree an effective and deliverable timetable.

The preferred option that we put forward during the workshops to support the methodology consultation is an **earlier date for submitting business plans – 2 December 2013**. This would allow more time for:

- engagement with companies and CCGs (and other stakeholders), particularly during the risk-based review. This could result in fewer resubmission plans;
- decisions on companies' proposals; and
- companies and CCGs to respond to our proposals, including making menu choices.

We will need CCGs' reports to carry out our risk-based review. So bringing forward the date for submitting business plans would also mean asking CCGs to provide their reports to us earlier – alongside companies' business plans on 2 December 2013. We expect companies to ensure that CCGs have sufficient sight of their final plans, including any late, material changes, to achieve our submission deadline.

We continue to engage with companies, and CCGs, about the best way to arrange the timetable. But it seems to us that an earlier submission date makes a significant contribution to the likelihood that the timetable can accommodate our proposed plans to implement menus and provide companies with the associated benefits of increased flexibility.

6.3 Setting price controls for small companies

We intend to consult further on setting price limits for small companies and potentially introducing a service incentive. We do not consider that our approach to setting price controls for small companies is critical to the delivery of our overall price control framework. So we will do this separately from our process for developing our price control methodology.

Appendix 1: Supporting data tables

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A1.1 Introduction

This appendix sets out draft guidance for the business planning data tables we intend to use. Since our methodology consultation only closed recently, the tables reflect the methodology set out in that consultation.

Unlike previous price reviews, where we provided company-specific data collection tables, this time we will provide one generic unpopulated set of spread sheets for each company to complete and return with their business plan. There are four sets of tables covering

- wholesale water;
- wholesale wastewater;
- retail (household and non-household);and
- appointee information.

This approach allows us to set each control separately, while still collecting information to meet our financeability duty for the appointed business as a whole.

We plan to collect some information relating to 2010-15 actual and expected performance in August 2013. A separate spread sheet is provided for this purpose.

Each of the sections that follow contain an 'at a glance guide' to the tables, their purpose and cross-reference to the August 2013 information (covered in detail in section A1.5).

Where this is not otherwise specified in individual tables, the price base for all cost information should be 2012-13.

A1.2 Wholesale water

Table A1 Wholesale water tables at a glance

	Data table	Contents
Outcomes	W1	Outcomes, performance measures, and associated expenditure
	W2	Proposed outcome delivery incentives, costs and benefits
Costs	W3 and W4	Information on wholesale costs and cost drivers (to set our baseline)
	W5	Information on asset values
	W6	Information on demand, connections, and metering
	W7	Historic abstractions above the abstraction incentive mechanism (AIM) threshold
	W8	Breakdown of demand by non-household group
	W9	Wholesale forecast revenues
	W10	Cost recovery rates
	W11	Proposed costs excluded from cost assessment and menus
	W12	Adjustment factors for the wholesale form of control
2010-15 performance adjustments	W13	Logging up and logging down claims (from the period 2010-15)
	W14	Costs associated with the overlap programme
	W15	Information to calculate capital expenditure incentive scheme (CIS) adjustments (this model is published on our website)
	W16	Information to calculate the operating expenditure (opex) roller adjustments
	W17	Information for the revenue correction mechanism (this model is published on our website)
Financeability	W18	Weighted average cost of capital
	W19	Wholesale returns

A1.2.1 Outcomes

In our methodology consultation, we said that we wanted companies to develop and propose outcomes and outcome delivery incentives that reflect their customers' views and priorities. In evaluating companies' business plans, we will need to take a view on their proposed outcomes, and associated incentives, to ensure that they deliver value for money and benefits for customers.

In their business plans, companies should propose a package of **outcome performance commitments**. They should be able to demonstrate that they understand the value their customers place on the delivery of particular outcomes. We expect companies to have carried out 'willingness to pay' surveys and collected other forms of evidence to back up their proposals, where appropriate.

For each outcome, we expect companies to specify the measure they will use to demonstrate delivery of that outcome. For each performance measure, they will also need to specify the level of performance they are committing to achieve – their **committed performance level**.

Committed performance levels should be cost-beneficial – that is, the expected marginal benefits should be more than the marginal cost of delivery. Companies may commit up to a level of performance that represents the economic level of service (that is, where marginal benefits equal marginal costs) within an acceptable and affordable overall plan.

As well as these outcome performance commitments, we proposed **outcome delivery incentives** that could be set based on the value that customers place on each outcome. We said that these could be expressed in different forms, for example:

- financial/non-financial;
- penalty only/reward and penalty; and
- trade-offs where benefits to customers are well evidenced.

Tables W1 and W2 are for outcomes relating to the **wholesale water** control. We suggested that where outcome performance commitments depend on activities governed by other price controls, we expect companies to propose that the incentive is applied through only one control. They could make contractual or other arrangements between these activities.

W1 – outcomes, performance measures and expenditure

This table sets out for each outcome:

- the **measures** used to demonstrate delivery of that outcome and the associated **committed performance levels**;
- the expenditure required to maintain existing performance levels; and
- the incremental expenditure to meet the committed performance level set for each performance measure.

Companies can include as many outcomes and performance measures as they need by repeating ‘Block B’, with as many performance measures as required for each outcome.

Since companies can choose their own outcomes and performance measures, we have not prescribed any definitions in this table. They should provide a definition of their performance measures as part of their business plans, as well as demonstrate that the proposed measure is appropriate for the outcome.

For each measure, companies should set out the current and expected performance level until the end of the current period (2012-13, 2013-14 and 2014-15). Where a company is proposing to deliver an outcome that has not been measured before, setting out the current performance level helps us to understand how the company has justified the expenditure to deliver incremental improvements.

Companies should include their committed performance levels until at least the end of the period (2019-20), for each performance measure.

In our methodology consultation, we discussed the duration of outcome delivery incentives. We said that we preferred to use outcome delivery incentives that are binding for the 2015-20 period only, but did not rule out longer-term assessments. Companies may wish to propose outcome commitments with performance measures for delivery over more than one price control period, consistent with their own longer-term planning horizons – and we said we are willing to work with companies to pilot such targets.

Where companies want to set a long-term target, additional years can be added to the table to demonstrate indicative future performance and expenditure. This includes the final deliverables planned.

The table includes two lines for expenditure:

- the totex required to maintain the existing (2014-15) performance level; and
- the incremental totex required to meet the committed performance levels (relative to maintaining the existing performance level).

We expect companies to demonstrate that committed performance levels provide the best value for customers, including providing appropriate information on both marginal costs and benefits to justify their proposals.

Where companies plan to maintain their existing performance level, they should represent this in the table by leaving the 'performance measure' line constant over the period. They should allocate all expenditure to the 'totex to maintain 2014-15 performance levels' line.

But where they plan to improve an existing performance level, they should allocate the expenditure on this outcome commitment between the expenditure to maintain the existing level of performance, and the incremental expenditure to meet their committed performance level.

Where customers are prepared to accept a reduction in the performance level because they value the cost savings more highly than the existing service offered, companies should include the costs of maintaining the 2014-15 performance level in the 'totex to maintain performance' line. Negative costs (that is, the costs being avoided) should be entered in the 'incremental totex to meet committed performance' lines.

The total wholesale expenditure for all outcomes should reconcile with projected total costs for all cost drivers in the wholesale cost assessment table W3.

W2 – outcome delivery incentives

This table has two purposes:

- for companies to demonstrate that customers support the **committed performance level** for each outcome; and
- for companies to estimate the **outcome delivery incentives** that should be associated with delivering each outcome.

Companies should include information in this table for each outcome and performance measure they have included in table W1. This includes those with no financial incentive attached because companies will still need to demonstrate in this table that the committed performance level is appropriate.

In our methodology consultation, we said that companies would need to consider the strength, form, and duration of incentives. Table W2 asks companies to set out the strength and form of incentives – but not the duration, as we proposed that outcome delivery incentives should only be binding for the 2015-20 period.

As with table W1, blocks can be added for each outcome and performance measure. This table contains four blocks to use, for each of:

- outcomes with no financial incentive (Block A);
- outcomes with penalty-only incentives (Block B);
- outcomes with reward and penalty incentives (Block C); and
- outcomes with trade-offs (Block D).

We described these types of outcomes in section 2.3 of our methodology consultation, as well as the framework for companies to decide which is appropriate for different outcomes. Companies will not necessarily choose to use all of these types in defining their appropriate outcome delivery incentives.

Outcome delivery incentives apply to any changes from the committed performance levels. This table asks companies to propose costs, benefits and incentive rates at other performance levels (that is, under- or over-delivery), expressed as changes from the committed performance levels. Companies should describe in their business plans how clearly the costs and benefits can be identified as just belonging to that outcome, and the quality of data on the costs and benefits associated with the outcome.

The costs, benefits, and proposed incentive rate for each performance level are set out in columns L to V. Column Q represents the central **committed performance level** for each performance measure, and should reflect the performance levels in table W1.

In the case of under-delivery, we would expect companies to signify the costs that could be avoided if they were to aim for a lower level of service and the benefits that would be foregone. The ‘proposed net incentive’ should indicate how much money would be returned to customers.

For over-delivery, companies should describe the additional benefits customers would receive through greater service levels. They can use the ‘costs’ and ‘benefits’ lines to demonstrate that their committed performance levels are at the economic level of service – and explain if it is not set at this level. But we do not expect companies to include the incremental costs for over-delivery, as the incentive rates should be based on customer willingness to pay rather than the costs (which we will expect to exceed willingness to pay if the commitment represents an economic level of service).

In estimating the ‘proposed net incentive’, companies should consider the calibration of outcome delivery incentives with other incentives. This includes incentives that apply across the whole business plan element (such as cost performance incentives), as well as those that are outcome specific (such as other regulatory incentives in place on companies to deliver statutory requirements relevant to the committed outcome). Companies should explain how they have taken these other incentives into account – for example, we would not expect them to propose an additional financial reward just for delivering a statutory obligation.

We do not expect expected costs and benefits to change in a linear manner with changes in the level of service delivered – and this table allows companies to decide the appropriate profile for each measure of success. We would expect companies to account for any obvious changes in the information it provides on costs and benefits. But when deciding on the appropriate incentive rates, companies should consider the advantages of accounting for different rates of ‘willingness to pay’ (or incremental and avoided costs) against the added complexity of having more than one incentive rate for rewards and penalties. They should set out their approach for each outcome and explain why this is appropriate.

Companies can also set out triviality thresholds for the application of delivery incentives related to each measure of success in this table. For deviations of performance within these thresholds, no incentive would be applied (that is, the threshold would be the level of service at which the incentive would start to be applied). This could be applied for measures of success where there is uncertainty in measuring actual delivery against the committed performance level. In these situations, companies may think it is inappropriate to apply an incentive unless a noticeable change in service occurred.

Beyond the triviality thresholds, the incentives will apply automatically based on performance during the next price control period – we will not consider the reasons behind performance levels, subject to any limits on incentive size proposed by companies.

Companies can also propose limits on the size of the incentives, based on customer views. For example, caps could be set on rewards at a level where customers are not willing to pay more for an additional improvement. Collars could be set on penalties at a level of performance that customers see as unacceptable to be below.

And they will need to consider whether incentives should be stepped or continuous.

- **Stepped incentives** are where different levels of incentive only apply when particular targets are reached (for example, the incentive applies at different levels for 0-9, 10-19, and 20+ incidents). Where an incentive follows this framework, companies should include each step in the table, along with the associated incentive. This approach could be used when the relationship between company activities and outturn performance is less certain, and so the company thinks the incentives should only apply with significant changes in performance.

- **Continuous incentives** are where the incentive is directly proportional to the measure of success (for example, the incentive is set at £X for each additional Ml/day or fraction thereof). For these outcomes, companies should set out levels between which a constant linear incentive rate applies, and specify any levels where the incentive rate changes.

  If there is only one constant incentive rate for rewards and (or) penalties companies would only need to set out the triviality threshold and the cap/collar (that is, the levels where the incentive starts and finishes) in addition to the rate. But they would still need to justify the committed performance levels and show any deviations in costs and (or) benefits.

For some measures of success, companies may wish to set annual committed performance levels and should set these out in table W2. We will account for any in-period under- or over-delivery when applying incentives at the end of the price control period. Companies should include further details on how they will be assessed mid-period, including any triviality thresholds around annual performance.

A1.2.2 Costs

So that we can set an independent baseline estimate of required expenditure, we need to collect information on costs and volumes for a range of expenditure drivers – both for the 2010-15 and 2015-20 price control periods. Our baseline estimate will use econometric models to help determine the level of total expenditure (totex) required for an average company at a business plan level.

We intend to collect information on expenditures for the 2010-15 price control period in August 2013. We will use this data to recalibrate our econometric models to include this historic information about cost drivers too.

W3 – water service expenditure by purpose

This table asks for the water service capital expenditure split by purpose. We have provided some sample expenditure drivers in the table but where these do not cover all actual or proposed expenditure, companies can add more.

We do not expect these expenditure drivers to reflect either the definitions or distribution of companies' outcomes and success measures in their plans for 2015-20, although we do expect that the totex described by these tables to equal the totex described by the outcomes table (W1).

Block B of this table asks for a breakdown of the funding of gross capex, including grants and capital contributions. Although we will consider gross capex and opex together as totex, we also need to net off other funding sources to assess the planned cost recovery rates.

Block C of this table asks for a breakdown of capex into different components. Although our totex approach means that we no longer plan to use this for cost assessment, we still need this information to calculate tax based on the splits of expenditure used for statutory accounting purposes.

W4 – explanatory variables for water service

This table contains the explanatory variables required to run econometric models. We would like companies to set out their planned performance against the defined metrics, which describe the scale or volume of company activities. We will use these to help set our baseline.

There is no need for companies to replicate these metrics as their measures of success, as we do not intend to use this information to challenge the scope of outcomes. But these projections should be internally consistent with those in table W1 so that they relate to the same projected totex.

For some explanatory variables, annual performance projections are required for each year of 2015-20. For others, only the concluding level of projected performance in 2019-20 is required. In this latter case, we will use the information to compare against equivalent performance projections for 2014-15 that are required in the August submission. If companies think they need to materially update this 2014-15 projection between the August and December submissions, they should submit these updated projections alongside the table.

W5 – asset information for water service

This table contains information about asset stock, asset condition and gross modern equivalent asset value (GMEAV) of relevant wholesale water assets as of 2012-13. Companies are not required to carry out a full periodic revaluation of their assets, but should carry out a 2012-13 valuation of their assets in line with their regulatory accounts.

This is to allow us to understand how the size and value of the asset base has changed over time. We may also use this information to help explain differences in expenditure for different companies when setting our wholesale water expenditure baseline.

This table is similar to information collected as part of the asset inventory we required at the last price review, although it uses the simpler approach recommended by Mott Macdonald/PricewaterhouseCoopers LLP in their report for UKWIR.

W6 – supply and demand balance information

This table asks for predictions of the volume of water delivered, properties connected, and metering programme. We need this information to set a baseline demand forecast for operating our wholesale adjustment factors, as well as helping us to check how these adjustment factors perform in dealing with demand risk.

We expect company demand predictions to be consistent with the 'weighted average water delivered' volumes in their water resources management plans (that is, an average across different predicted weather conditions).

W7 – abstraction incentive mechanism (AIM)

In our methodology consultation, we said that we would introduce an abstraction incentive mechanism (AIM). Table W7 provides information about over-abstraction in order to set the AIM incentive. It sets out information for all surface water sites which abstract from Band 3 surface water bodies, or groundwater sources that affect a Band 3 surface water body.

Block A asks for historic abstractions under the AIM threshold, which we will use to set a baseline for each site. Although we have not yet finalised what this threshold should be, we expect it to be a percentage of the environmental flow indicator (EFI) relevant to each site – for example, 50% of the EFI – and will clarify this before the business planning tables are finalised.

So that we can set a baseline for AIM, we intend to use historic data about over-abstraction levels. For each year from 2007-08 to 2012-13, companies should present the volume of water (in Ml) that has been abstracted from the relevant site at times when the flow in the associated surface water body is below the AIM threshold. This data should be consistent with information reported to the Environment Agency for abstraction licence monitoring purposes. The flow measurement should be at an Environment Agency, or Environment Agency-approved, monitoring station appropriate to the Band 3 surface water body and the abstraction point.

Where a substantive solution to over-abstraction problems – such as a restoring sustainable abstraction (RSA) scheme – is planned for any site during 2015-20, please indicate in the ‘Price review solution?’ column and describe when the solution will take effect and whether it is a full or partial solution.

For partial solutions, companies should estimate the percentage of their historic over-abstraction under the AIM threshold that the price review solution is likely to avoid – and provide some justification for this calculation. For example, if a company was abstracting 100 Ml/year from abstraction site B and the planned solution was likely to reduce this by 60Ml/year, then the planned solution would be recorded as a 60% solution for abstraction site B.

Companies should specify the source of the data in the ‘data source’ column. In particular, they should state what the flow measuring point was and whether this is an Environment Agency or Environment Agency-approved monitoring station for the abstraction site.

For groundwater sites only, companies should specify the percentage impact that the abstraction has on the associated Band 3 surface water body after one month. For example, 1 Ml/day of abstraction from site A might lead to a 0.45 Ml/day (45%) reduction in flow at the associated surface water body. Where a ground water site affects several Band 3 water bodies, companies should specify the percentage impact in total on all of the Band 3 surface water bodies after one month.

To calibrate the AIM incentive, we will assess the willingness to pay for AIM with national willingness-to-pay (WTP) data (available from the Environment Agency). Companies can propose additional local evidence if they wish.

W8 – non-household demand for water service

This table collects information on the projected number of properties, volume, and wholesale revenue forecasts for different groups of non-household customers. We will use this information to check that proposed default tariffs collect the right amount of revenue given the level of sales expected at these tariffs – since a component of default tariffs may be a volumetric rate based on the size of wholesale bills. As companies will set their wholesale charges to recover an allowed revenue, we will also use demand projections to estimate how the balance of wholesale charges might change over time for each group of non-household customers. We will use this as a reference point for comparing changes in wholesale charges from year to year.

We collected this type of information in the last price review to set limits to the weighted average charge increase (WACI) – which was set, given a total ‘revenue requirement’, using demand forecasts. The revenue correction mechanism adjusted for any difference between these forecasts and actual volumes. This is no longer the case, since the wholesale price limits will be set as limits to revenue, not to WACI.

This table is flexible, and companies can include any number of non-household groups. We would like them to give a name and eligibility thresholds (in Ml/year) for each tariff group. They should also include special agreements and unmetered customers in this table.

W9 – wholesale revenue projections for water service

This table breaks down total revenues that a company expects to receive in providing water services given the proposed price limits framework.

Lines 1 and 2 relate to revenue recovered from customers through the wholesale water price control (our methodology consultation explained our intention to include all wholesale charges and connection charges within the control).

Lines 3 to 9 relate to other regulated business revenue streams, and line 10 should sum these to reflect all revenues collected by the company.

We need information on income streams that do not form part of turnover as we must have regard to this income when setting our price limits, even though most of these income streams are not subject to wholesale price controls.

We have separated 'bulk supplies' into two lines, for agreements signed/to be signed before and on or after 1 April 2015. We have said that our water trading incentive is only likely to affect new trades, and this split allows this distinction to operate.

W10 – cost recovery

This table asks companies to provide their planned run-off rates and pay-as you-go (PAYG) rate relevant to the wholesale water totex projected in tables W1 and W3.

W11 – wholesale cost exclusions for water service

We think that most costs should be subject to the general cost performance incentives and risk framework. So companies will need to provide compelling evidence if they think a particular item of planned expenditure should be excluded from such incentives and the supporting cost assessment with the costs of that particular item assessed separately. They should explain whether they think that any such particular item should be excluded from the cost assessment, cost performance menus and (or) the general risk framework (for example, in the form of a notified item).

This table allows companies to provide details of the costs to be excluded, including historic data if they think that the item should be excluded from cost assessment. Companies can repeat this table to include all proposed exclusions as necessary.

Companies will need to explain:

- whether the item should be excluded from cost assessment, cost performance menus and (or) the general risk framework and why;
- the basis for the best estimate of expected expenditure, including the analysis that underpins it;
- the basis of the upper and lower expenditure limits, including the analysis that underpins it;
- the likely distribution of expenditure within these limits, including information on the distribution of the probabilities for the expenditures concerned (including P50 and P90 estimates);
- the basis of the relative cost, timing and output uncertainty;
- the measures planned to be taken to manage costs, and the basis of any residual lack of control that exists; and
- if a different cost recovery rate and associated incentive framework is more applicable to the excluded cost concerned.

It is for companies to make the case for any excluded costs. They should provide additional evidence where they think this is needed, including proposals on how any excluded costs should be treated.

W12 – adjustment factors for water service

In our methodology consultation, we said that we intended to use 'adjustment factors' to allow companies to collect more revenue if demand was higher than expected in finalising the price limits, but less revenue if demand was lower. The adjustments should relate to the marginal costs that companies would incur (or avoid) if demand in the control period was different to the levels expected in setting price limits. We proposed using both metered connections and volume as the adjustment factors for water, but none for wastewater.

This table asks companies to propose adjustment factors, which could vary for each year within the control period. Although we do not expect companies to include supporting evidence, we will expect them to be able to provide this on request.

A1.2.3 2010-15 performance adjustments

There are several adjustments we said we would make at this price control that relate to incentives we have already set for the 2010-15 period. This includes the:

- overlap programme, as well as shortfalls and any claims for logging up or logging down;
- capital expenditure incentive scheme;
- opex roller; and
- revenue correction mechanism.

The tables in this section allow us to make the relevant adjustments to the wholesale water control – other adjustments are covered in the 'wholesale wastewater' and 'appointee' tables.

W13 – water service logging up, logging down and shortfalls

Companies can use this table to claim for logging-up or to inform us of any shortfalls in output delivery and (or) items to be logged-down for the period 2009-10 to 2014-15.

Block A records the total aggregate claim for logging up, logging down and shortfalls. Block B is for each individual logging up claim, shortfall or logging down item, and can be repeated as many times needed. For each claim or item, companies should classify these as logging up, logging down, or shortfall.

We only expect logging up claims where a company has received confirmation of their eligibility for logging up under the 'Change protocol for 2010-15' (November 2009). Companies should explain their logging-up and logging down claims, including opex only where this is relevant.

W14 – water service overlap programme

This table will collect information about capital and operating expenditure associated with the schemes that overlap 2010-15 and 2015-20 – 'the overlap programme'.

Companies will be expected to demonstrate that their progress and the expenditure incurred towards delivery of these schemes are consistent with the proportion of total scheme cost assumed in the price limits set in 2009. They will not be allowed to benefit from lower than expected expenditure in the 2010-15 price control period if this is due to delays.

For each individual overlap scheme, companies should:

- include their 2009 business plan forecasts of total capital and operating expenditure for both 2010-15 and 2015-20 adjusted by any assumptions we set out in our final determination supplementary reports;
- include their actual annual expenditure incurred to date, along with the latest estimates of expenditure required to complete the schemes during the 2015-20 price control period; and
- explain which outcome the scheme will support in the 2015-20 period (with costs already included in table W1).

This will allow us to identify and assess any differences to the assumptions included in the existing price limits.

W15 – capital expenditure incentive scheme (CIS)

This table asks for information to calculate CIS adjustments. We explain this mechanism on our website, and we have already published our model for calculating these adjustments.

W16 – opex roller adjustments

This table asks for information to calculate the opex roller adjustments. This mechanism allows companies to keep operating cost savings for five years, regardless of when in the control period the saving is made.

W17 – revenue correction mechanism for the water service

At the last price review, we introduced the revenue correction mechanism (RCM), providing a financial incentive for companies to encourage consumers to use water wisely. The RCM is a way of sharing between companies and customers the benefits and risks of companies recovering more or less revenue than we assume when setting price limits.

For this price review, we will apply the RCM to correct for the differences between forecast tariff basket revenues and actual tariff basket revenues for the period 2010-15.

Alongside IN 11/04, 'Simplifying the revenue correction mechanism', which we published in May 2011, we published a spread sheet model for how the RCM will work.

This table collects the inputs we need to operate this model. While we can extract some of this information from the previously provided June returns and regulatory accounts, we will need some retrospective data for years 2009-10, 2010-11 and 2011-12 which was not collected in those annual submissions.

In IN 11/04, we explained that companies will not be compensated for the revenue losses arising from win-win tariffs. The table allows for this by ensuring that the losses are not included in the revenue shortfall report as part of the RCM. Revenue reductions arising from win-win tariffs are recorded in line 6 for each year from 2010-11. Companies should also provide their underlying workings.

A1.2.4 Financeability

W18 – weighted average cost of capital (WACC) for water service

This table sets out the assumptions companies make on the cost of capital for the provision of wholesale water services. This should be set out on both a pre-tax cost of debt/post-tax cost of equity basis (vanilla) and a fully post-tax basis.

Companies should provide this on the basis of:

- the company's actual capital structure which might, for example, be a more highly geared securitised structure; and
- a structure with levels of gearing consistent with our final policy on 'notional' capital structure.

This information is provided separately for the provision of the water wholesale service and the provision of the wastewater wholesale service. Companies should explain why there are differences between the costs of capital for water/wastewater, and (or) between actual and notional capital structures (if any).

W19 – wholesale returns for water service

This table compares a company's assumed cost of capital for the wholesale services against the actual returns that would result from the price limits proposed in its business plan. In doing this, the impact of these overall returns should be isolated from the impact on the return to equity.

If there is any divergence between the two, companies should explain why – including, for example, the impact of the incentive rates associated with their menu choice on wholesale costs.

This analysis is carried out on both the basis of a company's actual proposed capital structure and on the basis of a capital structure with levels of gearing consistent with the basis of the cost of capital in table W18.

A1.3 Wholesale wastewater

Table A2 Wholesale wastewater tables at a glance

	Data table	Contents
Outcomes	S1	Outcomes, performance measures, and associated expenditure
	S2	Proposed outcome delivery incentives, costs and benefits
Costs	S3 and S4	Information on wholesale costs and cost drivers (to set our baseline)
	S5	Information on asset values
	S6	Information on transferred private sewers (to set our baseline)
	S7	Information on large sewage treatment works (to set our baseline)
	S8	Breakdown of demand by non-household group
	S9	Wholesale forecast revenues
	S10	Cost recovery
	S11	Proposed costs excluded from cost assessment and menus
	S12	[Not used]
2010-15 performance adjustments	S13	Logging up and logging down claims (from the period 2010-15)
	S14	Costs associated with the overlap programme
	S15	Information to calculate CIS adjustments (this model is published on our website)
	S16	Information to calculate opex roller adjustments
	S17	Information for the revenue correction mechanism (this model is published on our website)
Financeability	S18	Weighted average cost of capital
	S19	Wholesale returns

A1.3.1 Outcomes

S1 – outcomes, performance measures and expenditure

S2 – outcome delivery incentives

Company business plans can have outcomes for water and wastewater that apply to either wholesale control. For wastewater, the tables for outcomes are identical to those for the wholesale water control – but for outcomes and performance measures relating specifically to the wholesale wastewater control. Companies should use the guidance for tables W1 and W2 to complete tables S1 and S2, substituting water outcomes for wastewater outcomes.

Tables S1 and S2 are for outcomes relating to the **wholesale wastewater** control. We suggested that where outcome performance commitments depend on activities governed by other price controls, we expect companies to propose that the incentive is applied through only one control. They could make contractual or other arrangements between these activities.

A1.3.2 Costs

To set an independent baseline estimate of required expenditure, we need to collect information on costs and volumes for a range of expenditure drivers – both for the 2010-15 and 2015-20 price control periods. Our baseline estimate will use econometric models to help determine the level of total expenditure (totex) required for an average company at a business plan level.

We intend to collect information on expenditures for the 2010-15 price control period in August 2013. We will use this data to recalibrate our econometric models to include this historic information about cost drivers too.

For the wholesale wastewater control, we have included more tables than for the wholesale water control. This is because the approach to cost assessment is somewhat different for wastewater.

As we explained in our methodology consultation, we need additional information about sewage treatment works to operate our proposed approach to cost assessment. We would also like information on the historic and projected costs relating to the transfer of private sewers in October 2011. Since these costs have not been incurred in earlier price control periods, our econometric models (based on historic costs) do not include this area of expenditure and we will assess this separately.

S3 – wastewater service expenditure by purpose

This table asks for the wastewater service capital expenditure split by purpose. We have provided some sample expenditure drivers in the table but where these do not cover all actual or proposed expenditure, companies can add more.

We do not expect these expenditure drivers to reflect either the definitions or distribution of companies' outcomes and success measures in their plans for 2015-20, although we do expect the totex described by these tables to equal the totex described by the outcomes table (S1).

Block B of this table asks for a breakdown of the funding of gross capex, including grants and capital contributions. Although we will consider gross capex and opex together as totex, we also need to net off other funding sources to assess the planned cost recovery rates.

Block C of this table asks for a breakdown of capex into different components. Although our totex approach means that we no longer plan to use this for cost assessment, we still need this information to calculate tax based on the splits of expenditure used for statutory accounting purposes.

S4 – explanatory variables for wastewater service

This table contains most of the explanatory variables required by the econometric models we propose to use for cost assessment. We would like companies to set out their planned performance against the defined metrics, which describe the scale or volume of company activities. We will use these to help set our baseline.

There is no need for companies to replicate these metrics as their measures of success, as we do not intend to use this information to challenge the scope of outcomes.

For some explanatory variables, annual performance projections are required for each year of 2015-20. For others, only the concluding level of projected performance at 2019-20 is required. In this latter case, we will use the information to compare against equivalent performance projections for 2014-15 that are required in the August submission. If companies think they need to materially update this 2014-15 projection between the August and December submissions, they should submit these updated projections alongside the table.

S5 – asset information for wastewater service

This table contains information about asset stock, asset condition and GMEAV of companies' wastewater assets as of 2012-13. Companies are not required to carry out a full periodic revaluation of their assets but should carry out a 2012-13 valuation of their assets in line with their regulatory accounts.

This is to allow us to understand how the size and value of the relevant asset base has changed over time. We may also use this information to help explain differences in expenditure for different companies when setting our baseline.

This table is similar to information collected as part of the asset inventory at the last price review, although it uses the simpler approach recommended by Mott Macdonald/PricewaterhouseCoopers LLP in their report for UKWIR.

S6 – information relating to transferred private sewers

This table asks for the costs and explanatory variables required to apply our cost assessment approach for transferred private sewers.

S7 – large sewage treatment works

This table asks for the explanatory variables required to apply our cost assessment approach for large sewage treatment works.

S8 – non-household demand for wastewater service

This table collects information on the projected number of properties, volume, and wholesale revenue forecasts for different groups of non-household customers. This is similar to table W8 for the wholesale water control, with the same purpose (as related to the wastewater service).

This table is flexible, and companies can include any number of non-household groups. We would like companies to give a name and eligibility thresholds (in Ml/year) for each tariff group. They should include special agreements and unmetered customers.

S9 – wastewater service revenue projections

This table breaks down total revenues that the company expects to receive in providing wastewater services given the proposed price limits framework.

Lines 1 and 2 relate to revenue from customers subject to the wholesale wastewater control (our methodology consultation explained our intention to include all wholesale charges and connection charges within the control this time).

Lines 3 to 8 relate to other regulated business revenue streams, and line 9 should sum these to reflect all wholesale wastewater revenues collected by the company.

We need information on income streams that do not form part of turnover as we must have regard to this income when setting our price limits, even though most of these income streams are not subject to wholesale revenue controls.

S10 – cost recovery for wastewater service

This table asks companies to provide their planned run-off rates and PAYG rate relevant to the wholesale wastewater totex projected in tables S1 and S3.

S11 – wholesale cost exclusions for wastewater service

We think that most costs should be subject to the general cost performance incentives and risk framework. So companies will need to provide compelling evidence if they think a particular item of planned expenditure should be excluded from such incentives and the supporting cost assessment with the costs of that particular item assessed separately. They should explain whether they think that any such particular item should be excluded from the cost assessment, cost performance menus and/or the general risk framework (for example, in the form of a notified item).

This table allows companies to provide details of the costs to be excluded, including historic data if companies think that the item should be excluded from cost assessment. They can repeat this table to include all proposed exclusions as necessary.

Companies will need to explain:

- whether the item should be excluded from cost assessment, cost performance menus and/or the general risk framework – and why;
- the basis for the best estimate of expected expenditure, including the analysis that underpins it;
- the basis of the upper and lower expenditure limits, including the analysis that underpins it;
- the likely distribution of expenditure within these limits including information on the distribution of the probabilities for the expenditures concerned (including P50 and P90 estimates);
- the basis of the relative cost, timing and output uncertainty;
- the measures planned to be taken to manage costs, and the basis of any residual lack of control that exists; and
- if a different cost recovery rate and associated incentive framework is more applicable to the excluded cost concerned.

It is for companies to make the case for any excluded costs, and companies should provide additional evidence where they think this is needed, including proposals on how any excluded costs should be treated.

S12 – [not used]

There is no table S12, but we have reserved this number for wholesale adjustments for the wastewater service (relating to the wholesale form of control). We have not proposed any such adjustments in our methodology consultation, but have left this open for now.

Other than tables S6 and S7, the tables have identical purposes across both the wholesale water and wholesale wastewater controls.

A1.3.3 2010-15 performance adjustments

There are several adjustments we said we would make at this price control that relate to incentives we have already set for the 2010-15 period. This includes:

- any claims for logging up or logging down;
- the overlap programme;
- the capital expenditure incentive scheme;
- the opex roller; and
- the revenue correction mechanism.

The tables in this section allow us to make the relevant adjustments to the wholesale wastewater control – other adjustments are covered in the 'wholesale water' and 'appointee' tables.

S13 – wastewater service logging up, logging down, and shortfalls

Companies can use this table to claim for logging up or to inform us of any shortfalls in output delivery/items to be logged down for the period 2009-10 to 2014-15. This table is identical to W13 for the wholesale water control, and should be completed in the same way.

Where a claim is made across water and wastewater together, companies should allocate the claim appropriately between tables W13 and S13, and explain how they have done this.

S14 – wastewater service overlap programme

This table will collect information about capital and operating expenditure associated with the wholesale wastewater schemes that overlap 2010-15 and 2015-20 – 'the overlap programme'.

Companies will be expected to demonstrate that their progress and the expenditure incurred towards delivery of these schemes are consistent with the proportion of total scheme cost assumed in price limits. They will not be allowed to benefit from lower than expected expenditure in the 2010-15 price control period if this is due to delays.

For each individual overlap scheme, companies should:

- include their 2009 business plan forecasts of total capital and operating expenditure for both 2010-15 and 2015-20 adjusted by any assumptions we set out in our final determination supplementary report;
- Include their actual annual expenditure incurred to date, along with the latest estimates of expenditure required to complete the schemes during the 2015-20 price control period; and
- explain which outcome the scheme will support in 2015-20 (with costs already included in table S1).

This will allow us to identify and assess any differences to the assumptions included in price limits.

S15 – capital expenditure incentive scheme (CIS)

This table asks for information to calculate CIS adjustments. We explain this mechanism on our website, and we have already published our model for calculating these adjustments.

S16 – opex roller adjustments

This table asks for information to calculate the opex roller adjustments. This mechanism allows companies to keep operating cost savings for five years, regardless of when in the control period the saving is made.

S17 – revenue correction mechanism for the wastewater service

This table collects information needed to operate the revenue correction mechanism for the wastewater service. It contains slightly different information for the wastewater service, although companies should use the guidance described under table W17.

A1.3.4 Financeability

S18 – WACC for wastewater service

This table sets out the assumptions companies make on the cost of capital for the provision of wholesale wastewater services. This should be set out on both a pre-tax cost of debt/post-tax cost of equity basis (vanilla) and a fully post-tax basis.

Companies should provide this on the basis of:

- the company's actual capital structure which might, for example, be a more highly geared securitised structure; and
- a structure with levels of gearing consistent with our final policy on 'notional' capital structure.

This information should be provided separately for the provision of the water wholesale service and the provision of the wastewater wholesale service. Companies should explain why there are differences between the costs of capital for water and wastewater wholesale services and (or) actual and notional capital structures (if any).

S19 – wholesale returns for wastewater service

This table compares a company's assumed cost of capital for the wholesale services against the actual returns that would result from the price limits proposed in its business plan. In doing this, the impact of these overall returns should be isolated from the impact on the return to equity.

If there is any divergence between the two, companies should explain why – including, for example, the impact of the incentive rates associated with their menu choice on wholesale costs.

This analysis is carried out on both the basis of a company's actual proposed capital structure and on the basis of a capital structure with levels of gearing consistent with the basis of the cost of capital in table W18.

A1.4 Retail

Table A3 Retail tables at a glance

	Data table	Contents
Outcomes	R1	Outcomes, measures of success, and associated expenditure for household customers
	R2	Proposed outcome incentives, costs and benefits for household customers
Costs	R3	Information needed to set the household average cost to serve (ACTS) control
	R4	Information needed to set non-household default tariffs
Financeability	R5	Retail margins for households and non-households

A1.4.1 Outcomes

We expect companies to put forward outcomes relating to retail services that reflect their customers' priorities. We propose to retain a SIM-like mechanism as the primary incentive for household retail outcomes. The SIM has been well received and appears to be driving delivery of retail services. So we consider it is an incentive worth keeping – but focused on household customers.

With a household SIM incentive in place, specific outcome delivery incentives should only be proposed for outcomes that are not already sufficiently incentivised by the SIM or other incentive mechanisms. We do not think there will be many such cases, if any. It is for companies to make the case for additional outcome commitments and associated incentives where they consider they are necessary.

Tables R1 and R2 collect information about outcomes for **retail** services proposed by companies. They follow a similar structure to the outcomes tables for wholesale services, except the totex for retail outcomes should be expressed as an incremental totex above the totex allowed under the 'average cost to serve' approach.

A1.4.2 Costs

Companies should include information in their business plans on their costs to serve each household customer. We need this on a comparable basis, since we will use it to calculate the average across the industry for our ACTS efficiency challenge. Our detailed approach and relevant options are set out in our methodology consultation, and will also require information on retail costs, customer numbers, and meters.

We have not yet finalised our approach to setting individual default tariffs for non-household customers. But whichever approach we take, we will need to ask companies to include proposals for their default tariffs in line with this approach. We will also need total costs, customer numbers and volume data so that we can cross-check total revenues expected under the default tariffs with total costs. We will also need data on costs and customer numbers broken down by the level of the tariff band so that we can be comfortable that no one group of customers is unduly price discriminated against.

R3 – information to set the household average cost to serve

This table collects all information about costs and customer numbers that we will need to calculate the ACTS.

Block A asks for the total retail expenditure for household customers. This is likely to be slightly different to the definition described in our accounting separation tables, to reflect the final retail definition. When we set out our final business plan requirements, we will be able to specify 'total expenditure' in more detail.

We ask for fixed expenditure in this block so that we can test financeability. This is expenditure that cannot be avoided in the short term, such as the depreciation of fixed retail assets and the fixed costs of buildings.

We ask companies to provide lines on debt management and doubtful debts so that we can compare debt across companies. This is only required if we allow adjustments for the drivers of doubtful debts. This expenditure should be included in the total expenditure line – the separate lines are to give additional granular detail.

We have not yet concluded whether we should use historic or forward-looking expenditure. This table will be adjusted as necessary to reflect this decision.

Block B asks for information about the costs of water efficiency initiatives and leakage repairs paid for by charges to the wholesale business (and funded through allowed revenue for a relevant wholesale outcome commitment). We need this information so that we can identify how much of this expenditure will instead be met through the retail service revenue allowed through the ACTS. Collecting the gross expenditure and the expenditure funded through wholesale allowed revenues will also provide a cross-check against the relevant wholesale totex allowed for the wholesale outcome commitments concerned. The net retail expenditure on demand-side water efficiency and customer-side leak repairs should also be included in the total expenditure line (Block A, line 1).

Block C asks for the additional costs incurred for providing retail services to metered customers over and above the cost of serving unmetered customers. This should be specified for water only, sewerage only, and water and sewerage customers, and are the difference between serving metered and unmetered customers. This difference will be used to calculate the proposed adjustments to the allowed household revenues for metering levels. For clarity, the ‘total operating costs’ line (in Block A) includes these costs.

Block D asks for the number of unique customers, in different categories. We will use numbers of customers as the denominator for our ACTS calculation and to calculate the metering adjustment to allowed revenues. It will also enable us to introduce an adjustment for economies of scope if we decide that an adjustment is appropriate.

Block E asks for the marginal retail costs to serve each type of customer. We will use this to assess the effects of the number of household customers and metering levels differing from central predictions, and test the effect of allowing adjustments to the retail allowed revenues to reflect different numbers of customers.

R4 – information to set non-household default tariffs

This table collects the information we will use to assess default tariffs.

Block A asks for the total costs for non-household customers – that is, the costs that will be met through the retail gross margin. We will use this to check that projected non-household retail costs are consistent with their historic levels and that, in aggregate, default tariffs are sufficient to cover total retail costs and provide an appropriate net margin.

As with household retail, we have asked for fixed expenditure so that we can test financeability. This allows us to examine the impact of changes in customer numbers.

Block B asks for information about the costs of water efficiency initiatives and leakage repairs incurred by the retail business but remunerated by the wholesale business (and funded through allowed wholesale revenues for a relevant wholesale outcome commitment). As with table R3, we need this information so that we can identify how much of the remaining costs will be met through the default retail tariffs. Collecting the gross expenditure and the expenditure funded through allowed wholesale revenues will also provide a cross-check against the relevant wholesale totex allowed for the wholesale outcome commitments concerned. As with household retail, the net retail expenditure on total demand-side water efficiency and customer-side leak repairs should be included in the total expenditure line (Block A, line 1).

Block C asks for these total retail costs to be allocated to each tariff band. In this section, we are asking companies to exclude financing costs (that is, excluding costs remunerated through the net retail margin proposed in table R5). We will use costs broken down to this tariff band level to assess whether or not the proposed tariffs mean any undue discrimination or preference between customer groups in different tariff bands.

Block D asks for the marginal retail costs by each tariff band. This allows us to assess how costs change with the number of customers when we are testing for financeability.

Block E asks for the total number of customers expected in each tariff band. We will use this, along with Block C and the total volumes provided in table W8 and S8, to estimate the revenue allocated to each default tariff band. This will enable us to cross-check that the revenues associated with customer volumes associated with the proposed default tariffs will recover the aggregate costs, set out in Block A.

Blocks F to I ask for proposed default tariffs. These tariffs are the gross retail margin elements only – the bills customers pay will include wholesale charges as well. We are aware that companies may have different approaches to setting such default tariffs for retail services, particularly in the balance between fixed and variable elements. We will expect the proposed default tariffs to recover the revenue allocated to each group of customers.

Blocks J to M ask for the charge multipliers for each element of the default retail tariffs. The charge multipliers follow the same methodology as used in the Principal Statements. Charge multipliers will need to be defined for each element of the tariffs. For example, for fixed charges, the relevant charge multiplier would be the number of customers (and so can be linked to Block E). For volume charges, the multiplier would be the total volumes expected to be used in that part of a tariff band. The charge multipliers will be used in conjunction with Blocks F to I to calculate the revenues that would be recovered by the default tariffs.

Blocks C to M are free-form tables, and rows can be added to accommodate the structure of each company's existing or proposed non-household tariffs.

Table R4 asks for proposed default tariff elements and charge multipliers, but we do not know yet how complex these are likely to be. These are the retail elements only, so are unlikely to include elements used in wholesale charges, such as surface area.

R5 – financeability assessment retail margins

This table asks companies what appropriate retail net margins should be for their household and non-household retail businesses. It also collects supporting evidence on the components of these net margins.

Block A allows companies to submit a proposed net margin for their household retail businesses. We have not yet concluded whether a net margin is needed in the household retail control. If we decide that one should be included, we will need companies to provide evidence of the level at which it should be set.

Block B asks for information to support the household retail costs covered by the element of the net margin that will remunerate working capital (Block A, line 1). This information will be used in our assessment of the need for a net margin.

Blocks C and D are similar to Blocks A and B, but for non-household retail.

Block E allows companies to propose different net margins for different customer groups. The total net margin recovered by the range of net margins proposed in Block E should recover an equivalent revenue to the aggregate net margin in Block C.

Block E is a free-form table; rows can be added as required.

A1.5 The appointed business

Table A4 Appointee tables at a glance

	Data table	Contents
Summary	A1	Price limits and average bills
Wholesale	A2	Wholesale financing and debt
	A3	Wholesale tax
	A4	Network management and network plus
	A5	Defined benefit pensions
	A6	Drinking water quality and environmental obligations
2010-15 performance adjustments	A7	Adjustments to RCV from disposals of land
Financeability	A8	Financial ratios
	A9	Inflation measures
	A10	Income statement
	A11	Balance sheet
	A12	Trade receivables
	A13	Other working capital assumptions
	A14	Cash flow statement
	A15	Fixed assets
	A16	Fixed assets – operating costs
	A17	Off-balance sheet debt
	A18	Grants and contributions
	A19	Operating profit and dividends analysis
	A20	Scenarios

A1.5.1 Summary

In order to meet our duties under Section 2 of the Water Industry Act 1991, we need to consider some elements of the business plans for each company as a whole. This includes some of the impacts on customers and on the ability of efficient companies to finance their functions. We have said that we will test the financeability of all price controls together – and we will do the same for the impact on total customer bills and the overall outcomes they pay for.

A1 – price limits and average bills

This table shows the impact of the business plan on household customers, across all the price controls.

Block A asks for the proposed wholesale K factors, including the initial revenue in 2015-16 – in our methodology consultation, we said that we proposed to set this directly in the first year.

The remaining sections ask for the average revenue and average bills for each of water and sewerage (if applicable), including the wholesale and retail elements separately.

A1.5.2 Wholesale

Some elements of setting wholesale controls apply across both water and wastewater – for example, calculating tax for the regulated entity as a whole.

A2 – wholesale financing

This table contains information about:

- the opening net debt;
- equity dividends payable over the price review period; and
- any cash flows relating to equity issues.

The financial ratios and RCV figures will be calculated by companies' financial projections in this table.

A3 – wholesale tax

This table contains the assumptions that would be used to drive the tax calculations in companies' financial projections.

Tax will be calculated separately for water and wastewater for the first time, as we will be setting separate price controls. Companies do not need to separate the 'brought forward' pools in Block A. Instead, we will apportion the allowances arising from this pool between water and wastewater.

For additions in the price control period, we will not collect information on different allowance pools. Instead, we require companies to supply only the average writing down allowance that applies to all of the expenditure by service (excluding deductible IRE).

A4 – network management and network plus

This table asks companies to forecast the costs to cover providing us with additional information on network management and network plus. In our methodology consultation, we said that we would allow companies an allowance for the costs of high-quality reporting in the wholesale price controls.

For network management, we propose asking an initial set of open-ended questions about companies' current network management practices and the models used for both water and sewage sludge activities. We will expect companies to provide flexible free-form answers to the first round of questions – we will not be expecting them to provide detailed evidence to explain their responses.

The answers to those first questions will help us to design more detailed questions and target specific data requests throughout the next control period. As the price control progresses, we expect to ask companies to provide increasingly more detailed cost driver and cost information. That information is likely to fall into the following categories.

- Physical balancing and short term cost minimisation.
- Co-ordination activities that would support the efficient functioning of the developing market and commercial arrangements.
- Providing clear charging arrangements and connection processes;
- Co-ordinating efficient network maintenance.
- In the medium and longer term, planning opportunities to ensure network resilience and minimise total costs.

We included an illustrative timetable in our methodology consultation on how the reporting requirements could evolve – and we plan to provide further information, including the initial round of questions, before we publish our final business planning statement.

For network plus, we do not expect companies to split their business plan submission according to network plus/resources/sludge, but can expect to seek this information within the period 2015-20. In our methodology consultation, we set out our intention to set non-binding sub-limits by 2017-18, and we will expect companies to be able to split their business planning tables according to these sub-limits for both water and wastewater.

A5 – defined benefit pensions

This table allows us to replace the accounting charge for pensions in our regulatory accounts with cash contributions to the scheme in our modelling. This should include both annual and lump sum contributions. Amounts should also be split between on-going service costs and deficit recovery payments.

A6 – drinking water quality and environmental obligations

This table provides information about total planned expenditure for meeting companies' drinking water quality and environmental obligations, for water and wastewater combined. This will help us to understand some of the variation in cost assessment models – for example, where companies have different levels of planned expenditure on environmental obligations.

In this table, we have included draft drivers from the National Environment Programme – which will be refined and confirmed by the Environment Agency in a future phase of this project. We will revise this table for the business plan statement to reflect these refinements, as this becomes possible.

For Block D, catchment management, we expect the costs to also be included in the relevant statutory driver lines in earlier blocks where appropriate. For example, expenditure to reduce pesticides that is being addressed by catchment management should be included in both the 'pesticide reduction' line and the 'catchment management programmes' line.

A7 – adjustments to RCV from disposals of land

This table derives the adjustment needed for the RCV for disposals of land expected in the current control period (2010-15). The benefits of such proceeds are split 50:50 between the company and customers (on an NPV neutral basis). Actual disposals for 2009-10 are compared to the estimate at the previous price review and the difference adjusted at 1 April 2015. Disposals of land include the creation of an interest or right in or over land – for example, the granting of leases and wayleaves. Proceeds from all such transactions are included.

A1.5.3 Financeability

We have a primary duty to ensure that efficient companies can finance their functions. When setting price limits, we interpret this duty as having two parts.

- To allow an efficient company a return consistent with a cost of capital that takes into account the risk in a given price limit package.

- To allow price limits that provide an efficient company the revenues, profits and cash flows that are sufficient to allow it to raise finance on reasonable terms.

In 'Future price limits – statement of principles', we said that we will set price controls in a way that gives companies ownership of, and accountability for, delivery of what customers want and need.

This section provides each company with the opportunity to demonstrate that it has a financeable business plan. But each company's business plan must be financeable in the context of:

- the risk being allocated to those best able to manage it; and
- the risk being borne by the company and its investors being rewarded at rates commensurate with that risk.

A8 – financial ratios

This table describes the key financial indicators and prescribes levels that have been used by the companies to determine that they will be able to raise debt and equity at rates consistent with the credit rating that they conclude to be appropriate.

This is done on the basis of the ratios:

- that are most applicable to each company's projected actual capital structure, reflecting those which are included in any actual debt covenants; and
- associated with levels of gearing consistent with a 'notional' capital structure – that is, on the same basis as it assessed the cost of capital in tables W18 and S18.

This table does not yet include our prescribed ratios for notional capital structures – but we will define these in the final business planning statement.

A9 – inflation measures

This table contains companies' assumptions about inflation during the price control period. This allows us to adjust the price base of business plans and compare across companies on a consistent basis – without prescribing assumptions about inflation.

A10 – income statement

This table is the income statement in an IFRS format. Companies' financial projections will be used to populate this table.

We have said that we will revise the regulatory accounting guidelines (RAGs) in time for the 2015-16 reporting year when the mandatory adoption of FRS101/FRS102 will take place. This means that over the 2015-20 period this projected table will be comparable to actual reported figures in the regulatory accounts.

A11 – balance sheet

This table is the balance sheet in an IFRS format. It comprises companies' projected position for 31 March 2015, with the remaining years coming from financial modelling projections.

We have said that we will revise the regulatory accounting guidelines (RAGs) in time for the 2015-16 reporting year when the mandatory adoption of FRS101/FRS102 will take place. This means that over 2015-20 this projected table will be comparable to actual reported figures in the regulatory accounts.

A12 – trade receivables

This table is the analysis of the trade receivables figure from the balance sheet. It comprises companies' projected position for 31 March 2015, with the remaining years from their financial projections. Line 14 of this table will equal line 8 of table A11 (the trade and other receivables line in the balance sheet). The 'debtor days' figures for all years entered in lines 15-18 will be the same as companies have used to calculate the receivables figures.

A13 – other working capital assumptions

This table includes the remaining inputs that companies have assumed for their financial projections, as required to produce the financial statements in an IFRS format.

A14 – cash flow

This table is the cash flow statement. It is in part an IFRS format, but it is tailored to give categories that are commonly used in the water and sewerage sectors – in particular, in the capex breakdown. Companies' financial projections will populate this table.

A15 – fixed assets

This table is the fixed asset closing position for each year in the price control period broken down into wholesale (split by non-infrastructure and infrastructure assets) and retail (split by household and non-household assets). It comprises companies' projected position for 31 April 2015, with the remaining years from their financial projections.

A16 – fixed assets: operating leases

This table collects information on assets acquired under operating leases, rental values, and minimum lease commitments.

A17 – off-balance sheet debt

This table collects information on off-balance sheet debt.

A18 – grants and contributions

This table collects information on the amount of grants and contributions actually received and those utilised during the year.

A19 – operating profit and dividend analysis

This table analyses the operating profit breakdown between retail and wholesale services, and also discloses the charge between wholesale and retail services. It also requires inputs for the dividends attributable to providing the wholesale and retail services separately.

A20 – scenarios

In our methodology consultation, we said that we need to understand how all the elements of the different price controls work together as an overall package. This will help to make sure that incentives are properly calibrated – and that the overall balance of risk and reward that companies face is appropriate.

More specifically, we need to assess the overall likely profile of companies' returns and financeability positions, given the range of potential risks (both positive and negative) and differing levels of company performance that exist. It is important that companies bear an appropriate amount of risk, as this is a necessary corollary of any incentive-based regulatory framework. Performance incentives are a key driver of better overall outcomes for customers.

As set out in section 3.3 of this document, we propose using use a scenario-based approach to modelling incentives and risks. In this section, we set out:

- the rationale for using a scenarios approach, and the key requirements of such an approach;
- the specification of nine scenarios, which we will use to carry out our analysis;
- how we intend to guide companies so that the base case business plans are prepared using consistent macro assumptions;
- how we intend to calibrate the individual scenarios; and
- the data required for each scenario.

Table A20 requests scenario information from companies. Each scenario is expressed as an upside case and a downside case compared to the company's business plan (which we will be able to use as a 'base' case, depending on the outcome of our risk-based review).

For each scenario, we have specified a standard set of data requirements. Companies should provide information on the incremental effects relative to the base case – if there is no impact, they should explain why.

In assessing the incremental effects, companies should consider the full range of financial impacts for each scenario. This includes any direct impacts, but also any taking into account any management responses to the relevant change in business conditions.

Companies should also provide a commentary to support their assessment of the scenario impact. This should include details of any calculations used to estimate the impacts – for example, companies should make it clear which (if any) of their outcome delivery incentives (ODIs) are affected under a given scenario and how. The commentary should also describe management responses to the change in business conditions.

Ofwat has a duty to ensure the financeability of efficient companies. Across all scenarios, we expect companies to explicitly include any actions they would take to mitigate the identified risks. In setting out evidence to support their modelling, we ask that they set out clearly which assumptions about mitigation have been included – and why they would not expect to take any further mitigation steps.

Scenario structure

We have specified five scenarios that are common across all companies. It is easier to assess if different business plans have an appropriate balance of risk and reward if companies assess some standard scenarios in response to common external risk factors (such as household growth or cost inflation).

The first three scenarios represent sensitivities of company performance to key wider economic risks. For each of these scenarios, companies should assume that all other variables remain at the levels specified in the base case in their business plans.

1. **Household growth.** In this scenario, UK residential household growth is assumed to be either higher or lower than assumed in the base case in the business plan. This is likely to impact both the wholesale and retail revenues and costs associated with the number of household connections. We chose this risk because we think it is the primary driver of the level of household demand and associated household-related costs and revenues.

2. **Industrial demand.** This scenario varies the growth of industrial output, which impacts the number of non-household customers on both default and non-default tariffs, as well as the amount of water and sewerage services demanded by each customer. This will impact the wholesale and retail revenues and costs associated with these non-household customers. This will be of particular importance to companies that have a large non-household customer base.

3. **Cost input inflation.** This scenario focuses on a change in construction output price index (COPI) and the costs of energy. We propose to analyse the impacts of construction and energy costs because these are arguably two of the most important input cost drivers for companies.

By requesting separate information on these three key risks, we will be able to assess the exposure of companies' business plans to different combinations of wider economic risk. For example, some recessions are predominantly demand-led and result in downward pressure on input costs. But other recessions can be triggered by external cost pressures, which is why we will review a range of economic scenarios.

The fourth scenario is an **overall economic** scenario. It combines the three scenarios above and also allows companies also to incorporate any other impacts arising from a weaker or stronger economy than the assumptions underlying the base case in the business plan. We have designed the 'negative' economic scenario to have both weak domestic demand and input cost pressure – and the 'positive' economic scenario to have strong domestic demand, but benign cost pressures. This means that there will be a greater sensitivity to economic risks compared with other potential economic combinations – for example, where lower demand is mitigated by the impact of reduced input cost pressure.

The fifth scenario is a proposed **rainfall** scenario. Weather conditions, including rainfall and temperature, can affect a range of costs and other incentives. To minimise the regulatory burden on companies we propose to analyse one key component of overall weather conditions – rainfall. We propose to analyse the impacts of a deviation in rainfall as this could have an impact on a range of wholesale and retail costs and revenues. High and low amounts of rainfall can lead to variations in expected water management and customer engagement costs. Also, the level of rainfall could impact companies' financial performance using the new targeted regulatory incentives such as the water trading incentive and the AIM.

We think that companies are best placed to identify any additional material company-specific risks. For this reason, we propose to give them the opportunity to supply us with the results from up to **two additional company-specific scenarios** for risks other than the wider factors above. These scenarios are to be provided on a voluntary basis and are intended to allow companies to demonstrate the impacts of the most important remaining risks. The scenarios could relate, for example, to specific investment programmes, to metering uptake or to deprivation. We want companies to take full ownership of these scenarios.

The eighth scenario focuses on financial consequences of variations in company **performance** relative to the level of performance assumed under the business plan – for both costs and outcomes. Under this scenario, companies should specify an upside case and downside case for their own performance with regard to the committed outcome levels in the business plan. They should provide information on the impacts associated with these, assuming the wider external circumstances covered by the previous scenarios remain as assumed in the base case for the business plan.

Finally, we propose that companies should provide their own combined upside and downside scenarios based on the full range of risk factors (including any relevant common and company-specific risks), as well as over- and under-performance by the company. In these cases, we want to elicit companies' views as to the totality of the plausible upside and downside risks they face, having incorporated relevant mitigations. So we want them to take ownership of these scenarios as well. We will ask companies to model the impacts of their combined upside and downside scenarios on customers and shareholders, and share the results of their modelling with us.

The overall scenario list is set out below.

Scenario	Title
Ofwat specified scenarios	
1	Household growth
2	Industrial demand
3	Cost input inflation
4	Overall economic scenario
5	Rainfall
Company specified scenarios	
6	Company-specific scenario 1
7	Company-specific scenario 2
8	Incentive performance variation
9	Overall scenario (economic, rainfall, company-specific risks and incentive performance variation)

So that we can analyse these scenarios consistently, we want companies to use common assumptions about underlying national economic conditions. So, we will provide a set of national assumptions. This will include assumptions on:

- GDP growth;
- RPI inflation;
- interest rates;
- unemployment;
- household growth;
- industrial output;
- Construction Output Price Index; and
- wholesale electricity prices.

Where possible, we intend to use Government forecasts – but where these are not possible, we will use independent forecasts or financial market data.

We will not require companies to use these figures in developing their own plans. But they should inform us when their assumptions differ materially, providing supporting evidence for the difference.

Rainfall differs from one company's supply area to another. So we will ask companies to explain the assumptions they have used about future rainfall in developing their business plans.

Scenario calibration

For each of the nine scenarios, we propose to require companies to assess the impacts of an upside case and a downside case around the base case business plan submission. For each of the indicator variables that change in each scenario, we will specify the upside and downside case as a deviation from the base case.

We will specify the ranges for indicator variables for each of the first five scenarios. These variables include:

- real GDP Growth;
- industrial demand;
- household growth;
- Construction Output price Index;
- wholesale electricity prices; and
- rainfall.

We propose to generate ranges for indicator variables based upon statistical analysis of historic variability, and for the economic indicators we propose to use a consistent macro-economic event shock. This means that the relationships between economic variables are consistent within each scenario – that is, the movement in household growth and industrial demand are both consistent with the changes in GDP that underpin the relevant upside and downside case in each scenario.

For the rainfall scenario, we propose to ask companies to estimate the impacts associated with a consistent deviation, in percentage terms, from the assumptions they have made on rainfall in developing their plans. Any other components of weather (such as temperature) should be held constant at levels assumed in the business plan. We welcome views from stakeholders on the calibration of this scenario.

The scenarios are designed to represent realistic high and low cases. They are not intended to reflect extreme possibilities, so there is a small risk that outturn results could fall outside the low–high range.

We have considered a uniform approach to generating the indicator variables and overall scenarios. This would involve a constant deviation from the base case value (for example, industrial demand is 5% lower than base case industrial demand in all years of the price control period). While this approach may be simpler to assess, it lacks realism. Instead, we plan to produce a profile for indicator variables that change over time. For example, this could mean that a weak economic scenario would include a reduction in economic growth followed by a period of recovery.

For the company-specific scenarios, companies will need to identify the relevant P10 and P90 reference points and provide estimates for these – that is, where there is a 10% chance of the key risk factor(s) being higher or lower than the assumptions used for the scenario.

A1.6 Cost information collection – August 2013

Table A5 Tables collected August 2013 at a glance

	Data table (BP table no.)	Contents
Wholesale – water costs	1 (W3)	Information on wholesale costs and cost drivers (to help set our baseline)
	2 (W4)	
Wholesale – sewerage costs	3 (S3)	Information on wholesale costs and cost drivers (to help set our baseline)
	4 (S4)	
	5 (S6)	Information on transferred private sewers (to help set our baseline)
	6 (S7)	Information on the costs of large sewage treatment works (to help set our baseline)
2010-15 performance adjustments	7 (n/a)	Service incentive mechanism (SIM) Collected in August 2013 and summer 2014

A1.6.1 Costs

We are planning to collect some data relating to 2010-15 in August 2013, rather than in the business plan. We want to use this data to improve our econometric models for wholesale cost assessment, by updating them to more recent years.

This includes forecasts for the remaining years of the current price control period (2013-14 and 2014-15). We will use these to update our econometric models – there will be no need to resubmit this data for this period in business plans.

For some items, we do not want data for every year of the current price control period. This is because we either already have the data – for example, most information for 2010-11 – or do not need this.

1 – Water service expenditure by investment driver (W3)

This table asks for the water service expenditure by purpose for 2008-09 until 2014-15. We have provided some sample expenditure drivers in the table but where these do not cover all expenditure, companies can add more. This focuses on capex because we will use this for unit cost models.

2 – Explanatory variables for the water service (W4)

This table contains historic and projected data on most of the explanatory variables we are likely to need for our econometric models. For years set out from 2010-11 to 2014-15, we would like companies to set out their historic and predicted performance against the defined metrics, which describe the scale or volume of company activities.

For some explanatory variables, annual performance projections are required for each year of the period 2010-15. For others, only the concluding level of projected performance in 2014-15 is required. In this latter case, we will use the information to compare against equivalent performance for the end of 2009-10.

3 – Wastewater service expenditure by investment driver (S3)

This table asks for the wastewater service capital expenditure by purpose for 2008-09 to 2014-15. We have provided some sample expenditure drivers in the table but where these do not cover all capex, companies can add more. This focuses on capex because we will use this for unit cost models.

4 – Explanatory variables for the wastewater service (S4)

This table contains historic and projected data on most of the explanatory variables we are likely to need for our econometric models. For years set out from 2010-11 to 2014-15, we would like companies to set out their historic and predicted performance against the defined metrics, which describe the scale or volume of company activities.

For some explanatory variables, annual performance projections are required for each year of the period 2010-15. For others, only the concluding level of projected performance in 2014-15 is required. In this latter case, we will use the information to compare against equivalent performance for the end of 2009-10.

5 – Information relating to transferred private sewers (S6)

This table asks for the costs and explanatory variables required to apply our cost assessment approach for transferred private sewers for the years 2010-11 to 2014-15.

6 – Large sewage treatment works (S7)

This table asks for the costs and explanatory variables required to apply our cost assessment approach for large sewage treatment works for the years 2011-12 and 2012-13.

7 – Service incentive mechanism (SIM)

The SIM performance scores will be used to determine the service incentive adjustments to allowed revenues from 2015.

A company's comparative SIM performance in 2011-12 and 2012-13 will be the basis of our draft determinations and will be collected in August 2013. Performance in 2013-14 will be used to update comparisons for final determinations, and we will tell companies when we will require this information in due course.

Comparisons will be made at total SIM score level, averaged over the two or three years.

The component level data will be used to check that the allowed revenue adjustments arising from this incentive do not make artificial distinctions between companies.

The component data may also be used to check the impact of any mitigating circumstances that a company may cite.

When providing their data companies should follow the published guidance, and explain any areas where their company systems yield data that varies from this guidance.

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

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