

Protecting consumers, promoting value, safeguarding the future

Change protocol for 2010-15

Principles and outline procedures for companies to
seek financial adjustments relating to
outcomes in the 2010-15 period

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1. Introduction

- 1.1 The price limits for 2010-15 that we have set for each company reflect our decisions on the proposals set out in its business plan.
- 1.2 These decisions took account of:
- the statutory [Social and Environmental Guidance](#) provided by both the Secretary of State for Environment, Food and Rural Affairs and the [Welsh Assembly Government](#) on the key Government policies we were expected to have regard to in setting price limits;
 - the [Statement of Obligations](#) provided by the Secretary of State for Environment, Food and Rural Affairs setting out the environmental and drinking water quality standards required to be met during the price review period; and
 - guidance on the actions necessary to meet these standards from the appropriate quality regulator.¹
- 1.3 Ideally, when we set price limits we would have complete certainty over what the companies will need to deliver during the price review period. However, experience has shown that changes will inevitably arise which could not be taken into account or foreseen when price limits were set. These changes may affect quality enhancement and other expenditure categories. They can arise from:
- new statutory obligations;
 - new scientific evidence (for example, on climate change); and
 - changing customer priorities.
- 1.4 Possible drivers during the 2010-15 period include:
- emerging evidence on climate change impacts, as reflected in the notified item;
 - finalising Water Resource Management Plans;
 - implementing the Water Framework Directive (WFD); and

¹ The quality regulators are the Environment Agency (working with Natural England and the Countryside Council for Wales) and the Drinking Water Inspectorate.

- impacts of rulings by the European Court of Justice on current infraction proceedings on the implementation of the Urban Waste Water Treatment Directive .
- 1.5 As the River Basin Management Plans to implement the WFD have not yet been finalised, it has not been possible to clarify their full implications for companies in time for setting price limits. In addition, the Environment Agency anticipates that companies may need to carry out more work before 2015. For example, this may require companies to carry out further investigatory work around the impacts of their assets to build understanding of the most appropriate, sustainable and best value means of achieving the WFD's requirements.
- 1.6 This change protocol therefore sets out a framework for dealing with the financial implications, where significant (as defined in paragraph 3.2), arising from changes to the improvements companies are required to deliver up to 2015. It reflects the changed circumstances following the introduction of the capital expenditure incentive scheme (CIS).

2. The purpose of the change protocol

2.1 This change protocol sets out the process that companies should follow if they are seeking financial recognition of significant output changes.

A change protocol submission may precede either:

- a **request for logging up or logging down**, whereby the financial implications of significant output changes in the current price limit period are taken into account at the beginning of the next price limit period; or
- an **'interim determination of K' (IDoK)**, as allowed for in certain clearly defined circumstances set out in company licences and notified items. This allows companies or Ofwat to seek a revision to price limits during the current period if changes occur that have an impact greater than the materiality threshold laid down in company licences.

2.2 **The process set out in this change protocol is concerned with clarifying the financial recognition of changes to the outputs assumed in price limits. It is entirely without prejudice to the need for each company to meet any new statutory obligation or carry out any activity arising from a statutory obligation. Companies must meet their statutory obligations, irrespective of the process set out in this document.**

2.3 The change protocol is not an alternative to the periodic review price setting process. We expect companies to take strategic ownership of their business plans and manage their investment programme flexibly to deliver the improvements required during the period that price limits cover.

2.4 The new arrangements introduced for 2010-15 through the CIS provide additional in-period flexibility for company decision makers. For example, they ensure that all actual capital expenditure will be recognised within a company's regulatory capital value. The symmetrical treatment of capital expenditure variance under the CIS reduces risk for companies.

2.5 Financial recognition of capital expenditure associated with changes to outputs will affect the final calculation of rewards and penalties under CIS in 2014. We set out our approach on this in appendix 1 for capital expenditure, whether recognised through an interim determination or through logging up or down.

- 2.6 In considering whether it needs to seek financial adjustments, each company must place any additional requirements in the context of its overall investment programme. Companies must identify the net financial impact of any related changes to capital investment requirements and timings, including any delays or reductions in related output requirements. Related changes are those associated with a specific change in circumstance or improvement programme driver (see appendix 2).
- 2.7 Companies must report to us if the net value of any reductions or delays to related output requirements is 'financially significant' (as set out in paragraph 3.2). The obligation rests with companies to provide us with reliable, accurate and complete information, within the bounds specified.
- 2.8 We will continue to monitor company performance in delivering outputs and improvement programmes through the June return and MD109 submissions, although we will review and revise the regulatory information we collect during the price review period. We will assess the cumulative impact of changes at the next price review. This will form the basis of our decisions on logging up, logging down and shortfalling.
- 2.9 We will ensure that our approach to judging output delivery does not stifle the identification of more innovative approaches to delivering compliance during the 2010-15 period.
- 2.10 We will consider financial recognition at the next price review for additional investigatory work you carry out to demonstrate to the satisfaction of the quality regulators that particular asset improvements are no longer necessary, or that quality outcomes can be achieved through a more efficient or sustainable approach, where this was not apparent when price limits were set. We expect companies to engage with both us and the quality regulators in this regard, and to agree the information required to confirm our approach to any changes.
- 2.11 We will review companies' performance jointly with the quality regulators throughout the period. In particular, we will work with them to understand and identify companies' performance in meeting any new requirements, including investigations, identified after price limits have been set.

3. The scope of the change protocol process

3.1 Changes to output requirements can arise from:

- changes to statutory outcomes or new evidence necessitating new actions (for example, as required by the quality regulators, or where evidence was incomplete when price limits were set);
- changes relating to any notified item (as confirmed in our final determination); and
- changes to service levels associated with an urgent customer priority (that is, any changes that are driven by customers, including changes in demand, rather than changes in statutory requirements).

3.2 The following chapters set out the process to be followed in each case when the changes to output requirements are financially significant. We consider changes to be ‘financially significant’ when the net present value of the costs or savings associated with the change up to the next pricing period exceeds 2% of the relevant service turnover. The impacts of related changes associated with a specific change in circumstance or improvement programme driver can be aggregated (see appendix 2).

3.3 In all cases, we expect companies to provide robust and clear evidence to us of the cost implications. We also expect companies to demonstrate that they have explored the options thoroughly, alongside evidence of dialogue with the quality regulators and/or customers and other relevant stakeholders as appropriate.

3.4 We expect each company to take the lead in managing its interactions and relationships with the quality regulators and other relevant stakeholders throughout the price review period. This includes:

- ensuring constructive dialogue between the company and quality regulators so that there is full clarity around changes to output requirements; and
- consulting quality regulators in identifying areas where output requirements can be flexed, while still meeting statutory obligations, to ensure best value for consumers.

3.5 Each company needs to demonstrate that it is working constructively with the quality regulators. This is a critical part of their overall approach to asset

management, and to demonstrating that companies are securing best value for their customers.

- 3.6 In particular, companies will need to work collaboratively with quality regulators on investigations around the impact of their assets and operations on achieving quality objectives and obligations. This is a vital input in determining whether they need to carry out further improvements, and, if so, how to deliver them through sustainable approaches that offer best value. If companies are unable to demonstrate that they have investigated improvement programmes properly, then it will be difficult for them to present robust evidence in support of future business plan proposals and regulatory submissions, with a potential impact on future regulatory funding.
- 3.7 Companies should not use their legal rights to appeal new consents as a means of delaying required improvements that are clearly identified. Appeals should be limited to cases where there is a genuine substantive issue at question.
- 3.8 The arrangements for taking into account operational expenditure associated with new outputs remain unchanged.

4. Changes to statutory requirements (or associated with a notified item)

- 4.1 The change protocol enables companies to seek appropriate financial recognition of changes to environmental or drinking water quality standards that arise after price limits are set, as confirmed in writing from Defra or the Welsh Assembly Government (WAG). Examples of such changes in the 2005-10 price review period included improvements required under the Shellfish Directive.
- 4.2 In these circumstances, a company must submit a report to us setting out evidence that:
- there is clear and unambiguous support for the new outcome from the quality regulators and/or standard setters, as appropriate;
 - it was not able to include the proposal in its final business plan;
 - the statutory deadline is such that work must be carried out before the next price review;
 - it is not able to otherwise accommodate the change within its existing investment programme (that is, it cannot identify changes to related outputs which offset its financial impact); and
 - the net impact of all related changes (that is, the changes associated with the change in policy or circumstance) is financially significant (see paragraph 3.2).
- 4.3 The procedure is as follows.
- i). The company submits an outline report setting out the reason for the proposed change and its relationship to statute. This should include evidence of support from the relevant quality regulator (where necessary). This should be copied to the Consumer Council for Water (CCWater), so that it can be kept abreast of the implications for future customer bills.
 - ii). We confirm within 20 working days whether or not we consider it appropriate for the company to submit a more detailed report seeking a financial adjustment.
 - iii). The company submits a more detailed report to us and CCWater within 90 working days. This includes:

- specific information on the nature of the proposed action and the date by which it must be completed;
 - evidence that it has fully explored the options with the appropriate quality regulator(s) and identified the solution that offers the best value. If the scheme(s) is/(are) outside the quality regulators' remit, the company will be expected to have consulted us before submitting the report;
 - any risks with the proposed course of action;
 - the audit report from the company's reporter on their cost estimates and exploration of possible solutions; and
 - the net financial impact of the proposed changes, arising from the change in policy or circumstance taking account of any offsetting reductions or delays in any previously financed outputs.
- iv). We will review the full report and advise the company within 40 working days as to whether we consider that financial adjustments are appropriate as a result of the revision to the company's agreed investment programme. This confirmation provides the company with assurance that, other things being equal, the reasonable net additional costs arising from the confirmed changes will be reflected in future price limits or, where applicable, through an interim determination. However, if further changes to related outputs, either up or down, arise before the next full price review, the company should tell us about these, so that we are able to reflect the full cumulative net impact of changes in future price limits.
- v). We will copy our advice to Defra and WAG, the appropriate quality regulator(s) and CCWater.
- vi). **The company should not use the change protocol process as a reason for delaying work that is required in order for the company to comply with a statutory or related obligation.**
- vii) The company will deliver the confirmed output by the dates agreed. Delivery of the new requirement will be monitored in the normal way using the June return and the annual updates of progress to CCWater.
- 4.4 This process is set out schematically in appendix 3.
- 4.5 Using this procedure implies that both the company and the appropriate quality regulators (where applicable) are in agreement about the need and
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justification for the change and the proposed solution. It is unlikely that we will confirm the changes that the company is seeking without support from the quality regulators. Any divergence of views between the company and the quality regulators on the costs or benefits should be set out clearly in both the outline and full submissions.

5. Changes to service levels associated with an urgent customer priority

- 5.1 The change protocol can allow companies to seek appropriate financial adjustments relating to significant changes to service levels, on the basis of customer support, provided certain conditions are met. Examples of such service enhancements could include resolving further sewer flooding problems or additional selective metering following a successful application for water scarce area status.
- 5.2 Such a request will be considered if the company provides evidence that:
- there is clear and unambiguous customer support for the new output;
 - it was not able to include the proposal in its final business plan;
 - it is not able to otherwise accommodate the change within its existing investment programme (that is, it cannot identify offsetting-related changes);
 - the work is an urgent customer priority and therefore should be started or delivered before the next price review; and
 - the changes exceed the threshold for financial significance (see appendix 2).
- 5.3 Under this procedure we would expect the company to prepare and submit a report to us (copied to CCWater). This should include:
- the nature of and justification for the proposed improvements, including compelling cost-benefit analysis (CBA);
 - evidence that it has fully explored the options, including with the relevant quality regulator where appropriate, and identified the best value option;
 - any risks with the proposed course of action;
 - the audit report from the company's reporter on its cost estimates and exploration of possible solutions;
 - the impact of the proposed changes on both price limits and average bills for the company's customers; and
 - evidence of a high level of support for the proposed changes from CCWater and other relevant stakeholders (or an explanation where this is not forthcoming), and evidence of customers' willingness to pay across the range of income groups.

- 5.4 We will review the full submission and advise the company and CCWater within 40 working days as to whether we will recognise the proposed change as a formal revision to its agreed outputs. This confirmation provides the company with assurance that, other things being equal, the reasonable net additional costs arising from the confirmed changes will be reflected in future price limits or, where appropriate, through an interim determination. However, if further changes to related outputs, either up or down, arise before the next full price review, the company should tell us so that we can reflect the full cumulative net impact of changes in future price limits.
- 5.5 The company will implement and deliver the new service enhancements by the dates agreed. Delivery of the new requirement will be monitored in the normal way using the June return and the annual updates of progress to CCWater.
- 5.6 This process is set out schematically in appendix 4.
- 5.7 Using this procedure implies that both the company and customers are in agreement about the need and justification for the change and the proposed solution. It is unlikely that we will confirm the changes that the company is seeking without support from CCWater. Any divergence of views between the company and CCWater on the costs or benefits should be set down clearly in the submission.

6. Minor changes to outputs

- 6.1 We expect each company to manage minor revisions to its investment programmes (that is, those that are not financially significant, as set out in paragraph 3.2) within the financial envelope of price limits. As we expect companies to manage their improvement programmes effectively, we do not require specific notification of each minor change in outputs or delivery dates. This allows companies greater flexibility and will reduce the administrative burden arising from the need to assess all minor changes. However, the company must, where required, liaise with the quality regulators or other stakeholders as appropriate, and obtain their formal agreement to the changes.
- 6.2 We will monitor delivery of the programme against that expected at the time of our final determinations through the June return and MD109 submissions. We will do this cumulatively over the price review period. We will also take into account changes subsequently agreed. Companies must retain an up-to-date assessment of the net financial impact of changes to their required outputs. If the net impact of any set of related changes (that is, those arising from a single change in policy or circumstance) is financially significant in a company's favour, it must report this to us. This will enable us to make appropriate financial adjustments. We expect companies to meet their obligation to provide us with reliable, accurate and complete information, within the bounds specified.

Appendix 1: Implementing financial adjustments and the capital expenditure incentive scheme (CIS)

Under the CIS, a company's actual capital expenditure during 2010-15 will be reflected in its regulatory capital value (RCV) at the end of the period. Therefore, the RCV will automatically include any expenditure arising from changes to required outcomes in the 2010-15 period. Logging up and down adjustments will thus result in only marginal changes to the calculation of final CIS rewards or penalties for 2010-15 (specifically the value of 'allowed expenditure' used in this calculation). Under the CIS, companies retain a given proportion of the difference between actual and 'allowed' capital expenditure through rewards or penalties.

For the purposes of calculating final CIS rewards and penalties to be implemented through ex post reconciliation payments:

- the amount a company claimed for logging up or down will be added to the 2009 final business plan capital expenditure forecast used in calculating its CIS ratio;
- the amount we accept will be added to the CIS baseline;
- the CIS ratio, efficiency incentive and allowed expenditure will be adjusted accordingly; and
- these revised values will be used, along with the company's actual reported capital expenditure, in calculating the total value of CIS rewards or penalties. Such changes will be marginal, reflecting the proportion of the additional expenditure against total service expenditure in the price setting period.

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The table below sets out an illustrative example of this.

	CIS calculations (without logging up of extra output)	CIS calculations (with logging up)
Company forecast capex	£210m	£210m + £12m (company estimate of extra capex)
CIS baseline	£200m	£200m + £10m (Ofwat estimate for extra output)
CIS ratio	105	105.7
Efficiency incentive	27.5%	27.1%
Allowed expenditure	£202.5m	£213m
Actual expenditure	£190m	£190m + £10m (actual expenditure on extra output)
CIS rewards/penalties	1.31% of baseline = £2.62m	1.21% of baseline = £2.54m

Note:

In this example, a company identifies an extra output. Its logging up claim estimates the cost of output at £12 million, while our estimate is £10 million, and the actual expenditure on the output is also £10 million. The actual capital expenditure is recognised in the company's RCV. The impact shown on CIS rewards/penalties is consistent with the CIS matrix and equations published in December 2008.

For capital expenditure handled through interim determinations, the existing regime for adjusting price limits, as set out in companies' licences, will continue unchanged for the 2010-15 period. But, as we set out in ['Capital expenditure for 2010-15: Ofwat's view on companies' draft business plans'](#) (December 2008), we will ensure that CIS-style incentives apply in a similar way to that set out in the table above for capital expenditure handled through an interim determination. This will avoid the creation of two parallel incentive regimes.

Therefore, in calculating the CIS rewards and penalties in 2014, we will take account of all capital expenditure. Our calculations will take account of the ratio of the company view of all (PR09 and IDoK) capital expenditure compared with our view (PR09 CIS baseline and IDoK assumptions), and the associated outturn position. The calculation of the ex-post reconciliation to deliver the appropriate net present value CIS reward or penalty will take account of in period financing effects, along with the impact of any adjustments to price limits through an interim determination.

Appendix 2: Assessing financial significance of changes

As we explained in our draft [CIS baseline](#) document, the CIS gives companies greater in-period flexibility. This is because capital expenditure is treated symmetrically and all actual expenditure will be recognised in companies' RCV from 2015 (see appendix 1).

In light of this, for 2010-15 we are setting a single threshold for 'financially significant' changes at a net present value of +/-2% of the relevant service turnover (water or sewerage) in the previous financial year, as set out in paragraph 3.2. This threshold will apply symmetrically to both companies and to us for interim determinations or logging up/down claims. We expect each company to manage changes to its programme below this threshold. This will help to focus in-period monitoring on more strategic issues rather than very detailed scheme-specific regulation. This threshold will also be used in assessing requests for interim determinations.

If a company has to finance capital expenditure on an extra output requirement that does not meet the 'financially significant' criterion of 2% of turnover, this expenditure will be included in its RCV automatically at the end of the period. However, there is potential for a small financial impact through the impact on the company's CIS rewards/penalties. The value of this impact is limited to a proportion (specifically the company's 'efficiency incentive' under the CIS) of any extra capital spend.

So, for example, a company with a CIS ratio of 100 will have an efficiency incentive of 30%. Any capital expenditure that it makes will be fully remunerated through inclusion in its RCV. However, all other things being equal, the company's CIS reward/penalty will be reduced by 30% of the capital expenditure variance associated with the extra requirement. In this case, the maximum financial exposure associated with a capital item that did not meet the 'financially significant' criterion would be 0.6% of turnover. This is significantly **lower** than the financial exposure of up to 1% of turnover under arrangements for 2005-10.

Our approach to the aggregation of changes remains unchanged, since this derives ultimately from the licence provisions relating to interim determinations. In general, we will continue the current practice of aggregating related changes associated with a specific change in circumstance or driver of the funded improvement programme for the purposes of testing whether a change is financially significant. It is for companies to make the case to us that changes are related.

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We will use our view of the reasonable net costs/savings associated with a specific change in circumstance in assessing the financial significance of a change.

Appendix 3: Process for dealing with changes to statutory outcomes



Appendix 4: Process for dealing with changes to actual service levels associated with an urgent customer priority

The company discusses the proposed change with its customers and other relevant stakeholders (eg CCWater) gains clear and unambiguous support for the new output across the range of income groups.



The company submits a report to Ofwat showing the nature and justification for the proposals (including CBA), details of the proposed solution, the reporter's report for cost estimations and the solution selected and details of any risks with the proposed solution. This should be copied to Crater.



Ofwat reviews the full report and advises the company within 40 working days as to whether it considers that financial adjustments are appropriate.



The company implements the agreed changes to the funded programme in line with dates proposed.



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