July 2013

Water today, water tomorrow

Setting price controls for 2015-20 – final methodology and expectations for companies' business plans

Appendix 5: Guidance on business plan tables

OFWAT

Contents

A5.1 Introduction

This appendix sets out final guidance for the business planning data tables we intend to use. The tables reflect our final methodology statement.

Unlike previous price reviews, where we provided company-specific data collection tables, this time we have provided 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 for the appointed business as a whole for our affordability and financeability tests.

Each of the sections that follow contain an 'at a glance guide' to the tables and their purpose.

Where this is not otherwise specified in individual tables, the price base for all financial information should be 2012-13 for forecast data (that is, 2013-14 onwards), or outturn prices for historic data.

Accounting standards

For data applying to years 2015-16 and beyond then the basis of this should be whichever accounting basis companies intend to adopt for 2015-16 – that is, historical cost IFRS, FRS101 or FRS102. But there are two areas where we will require companies to deviate from these standards.

1. **Revenue recognition** – RAG 3.07 prohibits the guidance in FRS5 to de-recognise turnover for amounts billed which companies deem to be uncollectable. We require this prohibition to be carried forward in your business plan projections. This means that IAS18.9 or FRS102(23.3) should be disapplied in this respect.

2. **Borrowing costs** – IAS23.8 requires borrowing costs to be capitalised where they directly relate to the construction of an asset. We require this rule to be disapplied. Similarly the option to capitalise under FRS102 (25.2) should not be taken.

We will continue to recognise IRE as an expenditure category after 2015-16. While for accounting purposes under IFRS, FRS101 or FRS102 this will be split between operating costs and capex, we will require companies to maintain transparency in the regulatory accounts so that comparisons can be made in respect of both total expenditure (totex) and tax calculations relevant for price controls in 2015-20.

Our information notice published in February 2013 set out a timetable for moving towards regulatory accounts that are aligned with IFRS.

Publication of populated tables

We do not intend to publish populated business plan tables as a matter of course, though we may decide to share some selected information with all companies where it is relevant to their own price controls. We will not share commercially sensitive information.

Information relating to the 2020-25 period

Several tables include a requirement to supply estimates of costs and other information relating to the 2020-25 period. We do not intend to hold companies to any plans included in these tables, but will use the information to estimate the potential impact of bills and potential future financeability after the price control period from the proposals in companies' plans. This is particularly important for this review, where incentives and cost recovery ratios mean that bills in future periods are affected and we are seeking evidence of longer term thinking underlying companies' business plans.

A5.2 Wholesale water

Table 1 Wholesale water tables at a glance

	Data table	Contents
Outcomes	W1	Outcomes, performance measures, and associated expenditure
	W2	Outcome delivery incentives
	W2a	Outcome delivery incentives - costs and benefits
Costs	W3 and W4	Information on wholesale costs and cost drivers (to set our baseline)
	W3a	Information on transitional expenditure
	W3b	Drinking water and environmental quality obligations
	W5	Information on asset values
	W7	Historic abstractions under 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	Water totex rolling reconciliation table
2010-15 performance adjustments	W13	Logging up, logging down and shortfall 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 for wholesale water
	W19	Wholesale water services returns

A5.2.1 Outcomes

Companies need to develop and propose outcomes and ODIs 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 consumers.

In their business plans, companies should propose a package of **outcome performance measures**. They should demonstrate that they understand the value that their customers place on the delivery of particular outcomes. We expect companies to have carried out appropriate benefits valuation assessments, such as 'willingness to pay' (WTP) or stated preference surveys, and collected other forms of evidence to back up their proposals, where appropriate.

For each outcome, we expect companies to specify the performance measure or measures they will use to demonstrate delivery of that particular outcome. For each performance measure, they will also need to specify the level of performance they are committing to achieve in return for the revenue allowed in price controls – their **performance commitments**.

Performance commitments should be cost-beneficial – that is, the expected marginal benefits of the changes proposed should be more than the marginal cost of delivering the changes. This is without prejudice to legal duties and statutory obligations which companies must continue to meet. For non-statutory measures, companies may commit up to a level of performance that represents the **expected** economic level of service (where expected marginal benefits equal expected marginal costs) within an acceptable and affordable overall plan.

As well as these outcome performance commitments, companies should propose **outcome delivery incentives** that should be set to reflect the value that customers place on each outcome. We have confirmed in the main methodology document that these can 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, W2 and W2a are to collect relevant information on outcomes relating to the **wholesale water** control. Where outcome performance commitments depend on shared activities that are also affected by other price controls, we expect companies to propose that the ODIs relevant to those commitments are applied through only one control. Consistent with their licence obligations, companies could make contractual or other internal arrangements to ensure the relevant shared activities are undertaken efficiently to secure the delivery of the performance commitments concerned.

Examples of filling in the three outcomes tables are provided in appendix X, which looks further at the calibration of ODIs with cost performance incentives.

W1 – wholesale water service outcomes, performance measures and expenditure

This table sets out for each outcome:

- the **performance measures** used to demonstrate delivery of that outcome and the associated **performance commitments**;
- the expenditure required to maintain outcomes at the 2014-15 level of performance; and
- the incremental expenditure to meet the performance commitments set for each performance measure for the 2015-20 period covered by the business plan.

This is a freeform table, but companies should not make structural changes to the table unless they are consistent with changes described in this guidance document. Companies can include as many outcomes as they need by repeating 'block X'. Each outcome can also have as many performance measures as required by repeating lines 5 and 6 from block A within each outcome.

Companies can choose their own outcomes and performance measures, they should, therefore, provide a definition of their outcomes and performance measures as part of their business plans, as well as demonstrate that the proposed measures are appropriate for the outcome.

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

Companies should include their performance commitments, for each measure, until at least the end of the next period (2019-20).Companies will be held accountable for delivering their stated performance commitments for each performance measure. Companies do not have to commit to a level of performance in each year (and so do not need to complete every cell), but each performance measure should have at least one performance commitment within the period which should align with the proposed incentives in table W2.

We expect companies to demonstrate that performance commitments provide the best value for customers, including providing appropriate information on both marginal costs and benefits to justify their proposals in table W2.

Following our consultation on the draft guidance, we have removed the requirement for companies to allocate the totex for maintaining 2014-15 performance to each performance measure from blocks A and X– instead, companies should identify the total expenditure required to maintain all outcomes at the 2014-15 level of performance in block Y.

Where companies are proposing to maintain the expected 2014-15 performance level for a given performance measure during the next control period, this should be demonstrated in the performance commitments line. All expenditure should be allocated to the 'total expenditure required to maintain all outcomes at 2014-15 level of performance' in block Y. No expenditure should be allocated to the 'incremental totex required to deliver the performance commitment' line.

Where companies are proposing to improve a performance measure, they should identify the additional expenditure required to deliver the change in performance and allocate it to the appropriate 'incremental totex required to deliver the performance commitment' line. All additional expenditure required to maintain the new level of performance in future should also be allocated to this line.

Block Y summarises the expenditure required to deliver outcomes. Companies should identify the total expenditure required to maintain the 2014-15 levels of performance for all outcomes.

We have confirmed that ODIs are binding for the 2015-20 period only, but we are not ruling out longer-term proposals. 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 – we are willing to work with companies to pilot such targets. These commitments will not be binding however.

In block Y, companies should include the on-going total expenditure required to maintain their 2019-20 outcome performance level throughout the period 2020-25. This allows us to look at the likely impact on bills in 2020-25 as a consequence of maintaining outcome performance commitments arising from 2015-20. Companies can also include indicative further outcome performance commitments, and additional expenditure to deliver these throughout the period 2020-25, in this table – but these are not compulsory. In any case, these performance commitments and levels of expenditure are indicative only; companies will not be bound to them.

Companies should, however, include their long-term ambition for each performance measure. This is the ultimate goal they are aiming for over the long term based on existing planning horizons and expenditure proposals, based on the desires and priorities of their customers.

All expenditure included in table W1 should be included in the total expenditure baseline. It should be net of any grants and contributions – and so the wholesale totex for all outcomes (block Y) should reconcile with the sum of lines 20, 21 and 23 in table W3.

W2 – wholesale water service outcome delivery incentives

The purpose of this table is for companies to propose 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 any proposed outcome commitments with no proposed financial incentive, where less information will be required.

As set out in section 4 of the methodology statement, we have confirmed our requirement for companies to consider the strength, form, and duration of the proposed delivery incentives, as well as the frequency of performance assessment. Table W2 asks companies to set out the strength and form of the proposed incentives, as well as the proposed frequency of assessment. However, it does not ask for the duration, as we have confirmed that all ODIs should only be binding for the 2015-20 period.

Incentive types

As with table W1, blocks can be added for each outcome and performance measure. The same lines should be copied for each outcome and performance measure. It should also copy the information for any 'trade-off portfolio' overall incentives. However, based on the proposed type of incentive, different information will be required. Where lines are not relevant, such as reward incentive lines for a penalty only incentive, the company should leave the cells in these lines blank.

For each performance measure for each outcome, the company should select which of the four incentive types is appropriate:

- no financial incentive;
- penalty-only financial incentives;
- reward and penalty financial incentives; and
- financial incentives subject to trade-offs.

We described these types of incentives in section 2.3 of our methodology consultation, as well as the framework for companies to decide which is appropriate for different outcomes, and confirmed this framework in section 4 of the main statement. Companies do not necessarily need to choose to use from all of these incentive types in defining their own appropriate proposed outcome delivery incentives.

The incentive strength should be set at the level of the performance measure and so different incentive types can be used for different performance measures within a single outcome.

For some outcomes, companies may wish to propose grouping outcomes together and therefore allowing trade-offs in performance across them. In these situations companies should estimate average WTP across all outcomes in the portfolio and apply this to an overall assessment of performance. To demonstrate this companies should include the usual lines for outcomes and performance commitments but should also include the lines for the overall portfolio incentives. Companies should also explain how the performance commitment levels for each outcome relate to the overall assessment and how they have been weighted to estimate the overall incentive rate.

Frequency of assessment and application

In determining the proposed performance commitments, companies should consider the frequency with which performance will be measured, as well as the frequency that associated delivery incentives will be applied. Customers may for example propose that performance is assessed annually and incentives estimated based on this performance. Alternatively, a company may take a longer-term approach that either looks at averages over a number of years or concentrates on delivery on the final performance commitment within the upcoming price control period.

Companies should use columns F-J to set out in which years performance will be assessed and the performance commitments in each of these years. It should align with the performance commitments identified in table W1. This should include the final performance commitment within the price control period as well as any intervening year in which the company's performance is proposed to be assessed on route to delivering the final committed level. Where performance is only proposed to be determined in one particular year of the price control period, companies should leave the performance commitments blank in the other years.

Where performance is proposed to be assessed within the period, companies may wish to propose that the associated incentive will be applied immediately – that is, within-period. Alternatively, companies may want to propose waiting until the end of the price control period so that in-period under- or over-delivery is accounted for and the incentive will be reflected in price controls for the following price control period. Companies should describe which approach they are proposing for each performance measure.

Deadbands and caps and collars

Companies may also set out 'dead bands' (that is, a range around the performance commitments) for applying delivery incentives related to each performance measure, both at the end of the price control period as well as associated with any annual performance assessments. For deviations of performance within these proposed deadbands, no incentive would apply. This could be used for performance measures where there is uncertainty in measuring actual delivery against the performance commitment. In these situations, companies may think it is inappropriate to apply an incentive unless a noticeable change in service occurred.

Companies should also propose controls on the size of the incentives where customers support this. For example, caps could be set on rewards at a level where customers are not willing to pay more for an additional improvement in performance level. Collars could be set on penalties at a level of performance that customers see as unacceptable to be below (and hence where alternative regulatory measures to secure delivery would be expected), or where there would be too much risk on the company associated with greater financial penalties derived from the proposed rates.

Outside the deadband range, the proposed incentives should apply automatically based on performance during the next price control period – subject to any limits on incentive size proposed by companies. If performance was poorer than that associated with any proposed penalty collar it would be expected that we will use other regulatory tools to determine reasons for the failure to deliver and consequences of it.

Incentive rates

In lines 8-11 and columns L-P companies should indicate the financial incentive rates (if any) they are proposing at different levels of service delivery, accounting for variations in incremental costs and WTP (where appropriate).

In principle, these cost and WTP variations may not be simple and so the relationship between WTP and costs may change at different potential levels of performance. But in practice, reflecting all such potential variations in proposed incentive rates (such that proposed incentive rates varied with different levels of performance) is likely to mean a complex and burdensome incentive framework. So it is up to the company to set out if, and how, it has simplified the estimates of WTP and cost in deriving practical incentive rate proposals (for example, by using a single proposed penalty rate within a given under-delivery range). We will assess the approach used as part of our risk-based review, looking favourably upon companies who can demonstrate better protection for customers in the practical approaches used.

The incentive rates should be separated into penalties, where incentives are associated with delivery of performance commitments assumed in the totex baseline, and rewards, where the incentive relates to the potential for actual delivery performance in excess of the outcome commitments that have been assumed in the totex baseline.

Where improvements are being proposed companies may have different performance commitments in different years. In such cases the incentives in relation to over-delivery and under-delivery should apply relative to the performance commitment level in each year. In this way, companies would automatically be rewarded for delivering early and penalised for delivering late in relation to a performance commitment for a given year. In these circumstances, separate penalty and reward incentive rates can be proposed for different years. Further information is provided in appendix 1.

For each proposed incentive rate, the company should provide the levels of service between which it will apply (columns L-M), the annualised WTP associated with a unit change, average incremental costs across the range and the actual incentive rate that will apply once the company has accounted for calibration with other incentives, such as the cost performance incentive, and any adjustments made to reflect uncertainty around the estimates. Further details on calibration with cost performance rates are provided in appendix 1 but briefly outlined below.

Calibration of incentives

It is the responsibility of each company to decide on and justify its approach to setting ODIs, taking full account of the calibration with cost performance incentives as well as other relevant circumstances (which may vary across different outcomes and elements of the business plan).

Companies should demonstrate how they have set their proposed outcome delivery incentive rates in practice - that is, how the outcome delivery incentive proposed (column P) has been derived from the incremental WTP rate (column N).This will depend on the actual nature of the outcomes and associated performance measures, and forms of delivery incentive proposed.

This should include consideration of incremental costs (column O) and the cost performance incentive, as indicated above, but also any other adjustments companies think are appropriate to make to derive the proposed outcome delivery incentive, for example accounting for uncertainties around the cost and (or) WTP estimates supporting the proposed commitment levels, or uncertainties over scope and timing (such as the exact nature of future statutory requirements).

Companies should explain their overall approach to setting the outcome delivery incentive, with particular emphasis on how it has accounted for cost performance incentives, as well as any outcome specific adjustments

Incentive units

Companies should set out the proposed units for each performance measure for which a financial incentive is proposed to apply in column D. Where the incentive rate applies only where there are noticeable ('step') changes in service, such as for every 10 incidents, companies should also explain this in this column.

Where companies are proposing steps in measured performance that are not consistently sized, they should explain this alongside their tables.

W2a – Cost benefit analysis

This table is for companies to demonstrate that there is evidence to support the **performance commitments** for each performance measure for each outcome, by setting out the costs and benefits associated with this, and other, levels of performance.

Companies should estimate the costs and benefits associated with departures from current levels of service. These should be annualised based on the whole life costs and benefits to ensure consistency with the incentives. Companies can find guidance on how to calculate appropriate annualised incremental costs and benefits in the report for UKWIR, Review of cost-benefit analysis and benefit valuation.

Companies' analysis should take account of the recommendations in the above report as well as those in the report for UKWIR, Carrying out Willingness to Pay Surveys. Where there are more appropriate means of estimation available for the costs and benefits concerned these should be explained and justified where applicable. Companies should also show evidence they have accounted for any lessons they have learned from their experience at the 2009 price review (PR09).

Companies should assess a number of potential performance levels. Companies should report the results of these in columns F–H (plus any additional columns the company chooses to add). This must include the performance commitment. It is for companies to decide how many columns they wish to include here, but as well as the performance commitment level companies will likely wish to include a level of service better and a level of service poorer than the performance commitment.

For some outcomes companies may set the performance commitment at the most economic level of service. However, for other outcomes this may not be the case. Where companies are committing to deliver this level for an outcome, they should include the economic level of service and associated costs and benefits in one of the assessed performance level columns. Companies should explain the reasons for the chosen performance commitment, including where necessary any reasons for it not being at the most economic level, alongside the table. We may challenge the reasons for doing so as part of our risk-based review.

For each performance measure, companies should set out annualised customer WTP for the different levels of performance. In most instances this should be estimated directly from research with the company's own customers, such as stated preference surveys or revealed preference studies. This WTP estimate should relate directly to the estimate used in setting the outcome delivery incentive. Where this is not the case, companies should explain the reasons why.

For each outcome the company should also indicate the size of other benefits, or disbenefits, relevant to the assessment of the outcome and decision over the appropriate performance commitment, but not directly relating to customer WTP for the performance measure.

The company should explain the sources of information, such as surveys carried out by the company or other studies, it has used in deriving the benefits estimates and incentive rates for each performance measure.

For each performance measure the company should also set out the annualised costs associated with the performance measure. These should be the costs to the company that feed through into the incremental cost estimate used in the calibration of the outcome delivery incentive with the cost performance incentive. This line should not include non-financial costs, such as negative environmental impacts – these should be included in the customer WTP or other benefits lines.

It is likely that companies' analysis will not be done separately by performance measures. Companies will instead be optimising their plans across all outcomes. Where costs and benefits are shared across outcomes or performance measures the company will need to make assumptions over the allocation of these – for example, as is necessary for allocating costs in table W1. Companies should describe in their business plans how clearly the costs and benefits can be identified to a given performance measure or outcome and explain if the required allocation has distorted any results reported in the tables.

A5.2.2 Costs

So that we can set an independent baseline estimate of required expenditure to deliver proposed performance commitments, 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 having regard to the expenditure drivers and the proposed performance commitments.

We are collecting information on expenditures for the 2010-15 price control period by 9 August 2013, as described in IN 13/05: August submission data requirements. We will use this data to update our econometric models to include further historic information about cost drivers.

W3 – wholesale water service expenditure by purpose

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

We do not expect these capex drivers to reflect either the definitions or distribution of companies' outcomes and associated performance measures in their plans for 2015-20, although we do expect that the gross totex described by these tables to equal the totex described by the outcomes table (W1). This should include the capex by purpose, operating expenditure, and other cash expenditure not included in operating expenditure.

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 in assessing totex, we also need to net off other funding sources to assess the planned cost recovery rates in order to determine allowed revenues.

Block C of this table asks for other cash expenditure. Where any accounting costs differ from cash costs, such as pension deficit costs, these should be included in this table where the expenditure is additional to that in blocks A and B (that is, these costs should not already be included within blocks A and B).

Companies should add extra lines for each separate expenditure item, and should explain the nature of the item concerned.

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

W3a – transition capital expenditure for wholesale water service

This table allows companies to identify the accelerated ('transition') water service capital expenditure they wish to make in 2014-15 to secure efficient delivery of proposed performance commitments in the first years of the next price control period (2015-20) – as explained in section 10 of the methodology statement.

The table asks companies to identify separately, the transition expenditure element included in total projected expenditure for 2014-15 that is purely associated with accelerated schemes that support outcome delivery over the 2015-20 period.

Companies will need to provide independent assurance and justification to demonstrate that the schemes being put forward under this mechanism are efficiently associated with performance commitments to be delivered in the next price control period.

To ensure consistency, companies should ensure their estimates of forecast transition expenditure are compiled on the same basis, using the same process and approaches, as the forecasts of expenditure for 2014-15 reported in table W3 – the transition expenditure should be included in the restated 2014-15 expenditures in W3. For those companies with an agreed overlap programme at PR09, the forecast expenditure needed to complete those schemes (and reported on separately in table W14) should not be included in this table.

W3b – drinking water quality and environmental obligations

This table provides information about total planned wholesale water expenditure for meeting companies' drinking water quality and environmental obligations. 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 its work. We have set out in the final statement how this future work will relate to our price controls process.

Since the consultation, we have updated these drivers to reflect consultation responses and split expenditure on investigations and actions.

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.

We have used the same table for both water and wastewater, so we expect some lines to be left blank where they are not applicable to wholesale water.

W4 – explanatory variables for wholesale 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 assessment of totex.

There is no need for companies to replicate these metrics as their measures of success. 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 projections are required for each year of 2015-20. For others, only the concluding level in 2019-20 is required. In this latter case, we will use the information to compare against equivalent projections for 2014-15 that are required in the August submission. If companies think they need to materially update this latter 2014-15 projection between the August and December submissions, they should submit these updated projections for 2014-15 alongside the table.

The final tables do not include **table W6**, which was included with the business planning consultation. We no longer need some of the lines in W6, and the remainder have been added to this table W4.

We expect company demand predictions in table W4 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).

W5 – asset information for wholesale 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 31 March 2013. 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 in the main it uses the simpler approach recommended by Mott Macdonald/PricewaterhouseCoopers LLP in their report for UKWIR.

W7 – abstraction incentive mechanism (AIM)

We propose to introduce the abstraction incentive mechanism (AIM) on a reputational basis for the 2015-20 price review period. Table W7 asks for information about over-abstraction in order to set up this AIM reputational incentive. It asks for information on all sites which abstract from WFD Band 1, 2 and 3 surface water bodies, or groundwater sites that affect Band 1, 2 or 3 surface water bodies. We will use this information to inform our final decision on the scope of the AIM.

Blocks A to D ask for historic abstractions, which we will use to set a baseline. Companies should report the baseline abstractions for each of the sites within scope (see the previous paragraph) below each of the two different thresholds; the Q95 of the recent actual flow (blocks A and C) and the Q70 of the recent actual flow (blocks B and D). We will use this information to inform our final decision on the flow threshold for the AIM.

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 threshold (specified in the block title). 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 affected surface water body and the abstraction point.

All sites which abstract from WFD Band 1, 2 and 3 surface water bodies or groundwater sites that affect Band 1, 2 or 3 surface water bodies (as specified above) should be included in the company's business plan table. We will work with companies and the Environment Agency to confirm the final list of sites to be included within the scope of AIM.

Where a substantive solution to over-abstraction problems – such as a restoring sustainable abstraction (RSA) scheme – is planned to be funded through allowed revenues 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 Q95 and Q70 thresholds 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 below the threshold and the planned solution (with associated expenditures included in tables W1 and W3) 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 confirm the name of the affected surface water body for all (surface water and groundwater) sites within scope in the 'Impacted surface water body' column.

Companies should specify the source of the abstraction baseline data in the 'abstraction 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 impacted band 1, 2 or 3 surface water body after one month in the "effect on water body (%)" column. For example, 1 Ml/day of abstraction from site A might lead to a 0.45 Ml/day (45%) reduction in flow at the affected surface water body. Where a groundwater site affects several band 1, 2 or 3 surface water bodies, companies should specify the percentage impact in total on all of the affected surface water bodies after one month.

W8 – non-household demand for wholesale 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 wholesale water services. This should be expressed as projected revenues under the company's business plan.

Lines 1 and 2 relate to revenue recovered from customers as limited by the wholesale water revenue control (our methodology statement 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 for the wholesale water service, and line 10 should sum these to reflect all wholesale water service revenues planned to be 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 controls, even though most of these income streams are not subject to the wholesale revenue controls.

We have separated 'bulk supplies' into two lines, distinguishing between revenue from qualifying agreements signed/to be signed after 1 April 2015 and other revenues. We have said that our water trading incentive is only applicable to affect new qualifying trades, and this split allows this distinction to operate.

Block D asks companies to include capital contributions from connection and infrastructure charges. This should not include any connection and infrastructure charges treated as revenue, which would already be included in line 2.

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.

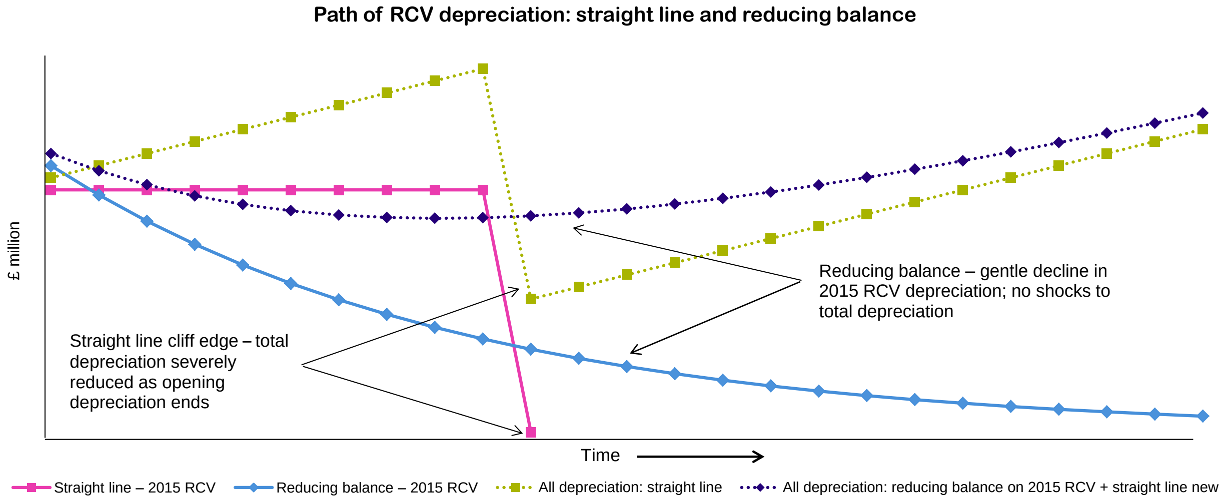
We have included the option of reducing balance depreciation on the 2015 regulatory capital value (RCV) because the application of straight line depreciation on this figure would be expected to cause a "cliff edge" effect were the company to adopt a constant run-off rate over several price reviews into the future.

This would be expected because with a constant run-off rate, all of the annual depreciation on the opening RCV would fall away at the same time, reducing revenue and prices substantially at that point and potentially placing severe strain on the company's financeability.

In contrast, using a reducing balance approach, the depreciation charge reduces gradually, so there is no step change in allowed revenue.

The diagram below shows a stylised view of the path of depreciation over time under the two approaches. Four lines are shown, as follows:

- straight line depreciation on the 2015 RCV – the solid pink line;
- reducing balance depreciation on the 2015 RCV – the solid blue line;
- total RCV depreciation made up of straight line depreciation on the 2015 assets and also on new spend – the green dotted line;
- total RCV depreciation made up of reducing balance depreciation on the 2015 RCV and straight line depreciation on new spend – the purple dotted line.



This diagram shows that using a reducing balance approach to the 2015 RCV avoids the 'cliff edge' of a straight line approach. Alternatively, companies could 'step down' the rate of 2015 run-off over future AMPs such that the decline in RCV flattens out. At this point the 2015 RCV would represent very long-life assets for which very little relative maintenance is incurred (such as dams or reservoirs).

For new spend, we only propose straight line depreciation as no 'cliff edge' effect would be expected – even using a single asset life, the fact that spend occurs every year would lead to a staggered ending of depreciation on new assets, rather than all ending at the same time.

In addition, this avoids the potential disadvantage of the reducing balance approach – that is, that depreciation on a particular year's additions never ends, becoming smaller and smaller in perpetuity.

This table asks for the planned PAYG ratio for both 2015-20 and 2020-25. This should be expressed as the percentage of totex that should be treated as PAYG. We do not expect companies to propose a different rate for individual years within the price control, but companies can include an average rate and explain why and how this should vary between years. We have asked companies to provide a PAYG ratio for 2020-25 to help us assess the expected change in bills after 2020.

W11 – cost exclusions for wholesale water service

We think that most wholesale water service expenditures should be subject to the general cost assessment, cost performance and risk framework. So companies will need to provide compelling evidence if they think particular costs should be excluded. For this purpose, excluded costs comprise the following:

1. Any proposed costs to be excluded from the general cost assessment to Ofwat's baseline totex estimates, including company specific factors;
2. Any proposed exclusions from the cost performance (menu) incentives;
3. Any proposed notified items; and
4. Any costs for which the company is proposing an additional mechanism to address risks associated with unplanned expenditure in-period.

Costs excluded from the cost performance (menu) incentives are still included in price controls.

In relation to 1, if we accept that we should exclude costs from our general cost assessment, we will still include those costs in our baseline totex estimate (that is, still included in menus). This includes proposals to adjust our assessment of the baseline totex to account for company-specific factors. We will only consider proposals where the costs are material and which include compelling evidence. We expect that most proposals will set out evidence of why past costs incurred by the industry will not be a good predictor of future costs incurred by the company.

In relation to 2, 3 and 4, we will only consider costs for exclusion if they are material; very uncertain; and outside the reasonable control of management. Uncertainty can comprise: cost uncertainty; output uncertainty; or timing uncertainty.

This table allows companies to provide summaries of their proposed cost exclusions (which can relate to a whole cost or a change in cost). Companies should repeat this table to include all proposed exclusions as necessary.

We expect companies to provide a compelling and well-evidenced case for any proposed exclusion alongside the data provided in the table. This will need to include the following information.

For all types of cost exclusion (1, 2, 3 and 4 from the list above)

- An explanation of the company's proposal for the excluded cost, including how it should be treated and whether it relates to a whole cost or a change in cost;
- the basis for the company's estimates of expected operating and capital expenditure used for the purpose of its business plan, including the analysis that underpins them;
- the basis of the median, P10 and P90 expected operating and capital expenditure estimates, including the analysis that underpins them;
- the likely distribution of expenditure within these limits, including any further information on the distribution of the probabilities for the expenditures concerned;
- a full explanation of any identified cost (including any cash costs which should be identified separately), timing and output uncertainty;
- an explanation of where the identified costs are included elsewhere in the business plan; and
- the sensitivity of the costs presented in this table to any information presented in tables W1, W2, W3 and W4.

For cost exclusions covered by 2, 3 and 4 in the list above

In addition to the information described above companies should also provide the following information for any proposed cost exclusions covered by 2, 3 and 4 in the list above:

- the measures planned to be taken to manage costs, and the basis of any residual lack of control that exists;
- an explanation setting out why the company believes that it is not best placed to manage the identified cost uncertainties using just the general cost performance incentives from menus, a proposal for how these uncertainties are instead best managed via alternative incentives, and how customers will be impacted by the proposed cost exclusion; and
- (for any proposed menu exclusions) whether the company considers that a different cost recovery rate is more applicable to the excluded cost concerned.

W12 – totex reconciliation table

This table summarises and quantifies the reasons why companies expect wholesale water totex to change for each year between 2012-13 and the end of the price control period, 2019-20, consistent with the information provided in previous tables.

At a high level, the table allows for changes in totex to arise from changes in the level of activity in respect of either 2014-15 outcomes or additional performance commitments, Real Price Effects (RPEs) associated with the costs, and efficiency, and changes in the level of menu exclusions – that is, costs which companies view as material, highly uncertain and outside reasonable management control.

The table is in four distinct parts as follows.

- Part A provides a reconciliation for 2012-13 from projected totex to projected totex less menu exclusions and accounting one-off costs.

- Part B rolls the result of Part A forward in respect of the totex associated with achieving and maintaining outcome performance levels in 2014-15. Part B shows separately the effects of activity level variations, changes in RPEs and net efficiency, and menu exclusions. The totals should agree to table W1 for totex in respect of 2014-15 outcomes. The table asks for RPEs and cost efficiency to be shown separately because this increased granularity will assist in our comparative analysis of company plans.

- Part C shows separately totex on variations in performance commitments expected to be achieved after 2014-15 including the causes of these total variations – showing separately the effects of activity level variations, changes in RPEs and net efficiency, and menu exclusions. The totals should agree to table W1for totex in respect of committed performance levels for 2015-20.

- Part D is a total table formed from adding the tables shown in Part B and C. Therefore, it is entirely calculated.

A5.2.3 2010-15 performance adjustments

There are several adjustments we said we would make in this price review 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 service control – other adjustments are covered in the 'wholesale wastewater' and 'appointee' tables. In line with our decision in the statement, no 2010-15 performance adjustments will be reflected in the retail controls.

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 in relation to the integrated regulated water service.

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 agreed water service schemes that overlap 2010-15 and 2015-20 – 'the overlap programme'.

Companies will be expected to demonstrate that their progress towards delivery of these schemes and the associated expenditure incurred are consistent with the proportions of total scheme cost assumed in the price limits set in 2009 for each of the agreed schemes concerned. They will not be allowed to benefit from lower than expected expenditure in the 2010-15 price control period if the lower expenditure is due to delivery 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 remainder of the 2010-15 price control period and the 2015-20 price control period; and
- explain which outcome performance commitments 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, as well as understanding the connection to new outcome commitments.

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.

Table W3a allows companies to identify transition capital expenditure for wholesale water. We said that we would exclude this transition expenditure from the CIS reconciliation for the 2010-15 period.

W16 – opex roller adjustments

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

Our methodology statement explains that we will apply the opex roller without enhanced multipliers. Companies should refer to the methodology statement when completing this table.

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 controls.

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.

A5.2.4 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
- an assumed 'notional' structure with levels of gearing consistent with their expectations of an appropriate capital structure.

In the methodology statement, we said that companies should use a notional capital structure with a notional gearing of between 60% and 70%. Companies should explain their assumptions for the purposes of completing the notional WACC in block B.

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 controls 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 assumed cost of capital and actual returns, companies should explain why.

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

A5.3 Wholesale wastewater

Table 2 Wholesale wastewater tables at a glance

	Data table	Contents
Outcomes	S1	Outcomes, performance measures, and associated expenditure
	S2	Outcome delivery incentives
	S2a	Outcome delivery incentives – costs and benefits
Costs	S3 and S4	Information on wholesale costs and cost drivers (to set our baseline)
	S3a	Information on transitional expenditure
	S3b	Drinking water and environmental quality obligations
	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	Wastewater totex rolling reconciliation table
2010-15 performance adjustments	S13	Logging up, logging down and shortfall claims (from the period 2010-15)
	S14	Costs associated with the overlap programme
	S15	Information to calculate capital expenditure incentive scheme (CIS) adjustments (this model is published on our website)
	S16	Information to calculate the operating expenditure (opex) roller adjustments
	S17	Information for the revenue correction mechanism (this model is published on our website)
Financeability	S18	Weighted average cost of capital for wholesale wastewater

	S19	Wholesale returns

A5.3.1 Outcomes

S1 – outcomes, performance measures and expenditure

S2 – outcome delivery incentives

S2a – cost benefit analysis

Business plans for water and sewerage companies can have outcomes for the wholesale services relevant to setting both the water and wastewater controls.

For wastewater, the formats of the tables for outcomes are identical to those for the wholesale water control – and should be used for outcomes, performance measures and commitments, and associated incentives, relating specifically to the wholesale wastewater service control. Companies should use the guidance for tables W1, W2 and W2a to complete tables S1, S2 and S2a, substituting water outcomes by wastewater outcomes.

Tables S1, S2 and S2a are to collect relevant information on outcomes relating to the **wholesale wastewater** control. Where outcome performance commitments depend on shared activities that are also affected by other price controls, we expect companies to propose that the ODIs relevant to those commitments are applied through only one control. Consistent with their licence conditions, companies could make contractual or other internal arrangements to ensure the relevant shared activities are undertaken efficiently to secure the delivery of the performance commitments concerned.

A5.3.2 Costs

So that we can set an independent baseline estimate of required expenditure to deliver proposed performance commitments, 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 having regard to the expenditure drivers and the proposed commitments.

We are collecting information on expenditures for the 2010-15 price control period by 9 August 2013, as described in IN 13/05: August submission data requirements. We will use this data to update our econometric models to include this historic information about cost drivers.

Other than tables S6 and S7, the tables have identical purposes across both the wholesale water and wholesale wastewater controls. Companies should use the guidance for the equivalent wholesale water tables where applicable.

For the wholesale wastewater control, we have included additional tables at S6 and S7. 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 approach to cost assessment. We would also like information on the 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.

As set out in section 5 of the main statement we have decided to apply the different approaches to cost assessment as proposed in our consultation and so require companies to provide us, in their business plans, with the additional information required for the purpose.

S12 – totex reconciliation table

This table is identical for wholesale water and wholesale wastewater, except that expenditure on the adoption of private sewers should be shown separately in the wastewater table.

A5.3.3 2010-15 performance adjustments

The tables for 2010-2015 performance adjustments apply to wholesale wastewater in a similar way to the wholesale water tables. Companies should use the guidance for the relevant water tables.

Table S3a allows companies to identify transition capital expenditure for wholesale wastewater. We said that we would exclude this transition expenditure from the CIS reconciliation for the 2010-15 period.

A5.3.4 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
- an assumed 'notional' structure with levels of gearing consistent with their expectations of an appropriate 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 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 controls 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 assumed cost of capital and actual returns, companies should explain why.

This comparative 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 S18.

A5.4 Retail

Table 3 Retail tables at a glance

	Data table	Contents
Outcomes	R1	Outcomes, measures of success, and associated expenditure for household customers
	R2	Outcome delivery incentives for household customers
	R2a	Outcome delivery incentives – costs and benefits
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

A5.4.1 Outcomes

We expect companies to propose performance commitments relating to the provision of retail services that reflect their customers' priorities. As set out in section 4 of the final statement, we will retain a SIM-like mechanism as the primary incentive for household retail services and non-household retail services in Wales.

With a SIM incentive in place, specific ODIs should only be proposed for retail outcomes that are not already sufficiently incentivised by the SIM or other incentive mechanisms. There may not be many such cases, if any, for regulated retail services that need to be funded by the revenues allowed for in price controls. It is for companies to make the case for additional outcome commitments and associated incentives where they consider they are necessary to meet customer priorities.

We do not expect companies to propose any financial retail ODIs for non-household customers that will be able to choose their retail supplier within the price control period.

Tables R1, R2 and R2a collect information relevant to outcomes for **retail** services proposed by companies. They follow a similar structure to the outcome tables for wholesale services. However the year for comparison differs from the wholesale tables. This is because allowances under the ACTS will be based on historic costs. Total expenditure ('totex') associated with performance commitments should cover:

- the incremental totex associated with performance commitments where performance is different to expected levels of performance in 2013-14 (the year on which the ACTS allowed revenues will be based); and
- the incremental totex compared with the 'base' level set out in business plans.

  – For household retail, the base level of totex will be the sum of lines 1, 2 and 3 in block A, table R3.

  – For non-household retail, the base level of totex will be the sum of line 12 in the repeated block C in table R4 for each tariff band for which the outcome applies.

A5.4.2 Costs

Background

The guidance provided for the retail operating cost information required in tables R3 and R4 refers to the definitions provided in regulatory accounting guideline 4.04 (RAG 4.04).

RAG 4.04 represents accrued operating expenditure that, combined with forecast depreciation on new (AMP6) retail assets, will be the basis of the ACTS calculation. The financing of working capital and the return on new retail assets will be remunerated through the net margin.

RAG 4.04 was last updated in February 2013 and aligned to our preferred definition of retail proposed in our consultation 'Setting price controls for 2015-20 – framework and approach'. Following this update, we carried out a targeted review of accounting separation cost allocations relevant to the costing of retail services for setting price controls. This review identified some inconsistencies in the way companies interpreted the line definitions provided in RAG 4.04. A further inconsistency was identified through the parallel methodology consultation process, relating to a lack of clarity on the definition of household and non-household.

The targeted review also recommended that we require companies to allocate general and support expenditure between retail and wholesale, and to allocate retail costs between household and non-household, on a consistent basis.

In response to these identified inconsistencies, we provide guidance clarifications, which companies must follow when compiling the data in the retail (and affected wholesale) costs tables for their business plans. We provide details of the implications of these required allocation bases at the end of this section.

As explained section 2 of the final statement, the business plans also need to reflect our decisions on the scope of retail services for the purposes of setting price controls. Table 4 at the end of this section summarises where the business planning guidance differs from RAG 4.04 and where it provides clarification of the definitions.

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 average cost to serve (ACTS).

Block A, line 1 asks for the total retail operating expenditure for household customers. The definition of retail expenditure is included with the table. This reflects the final policy decision on activities that are carried out by retail and those that are carried out by wholesale. The definition for total expenditure is total operating expenditure excluding third party services (as per RAG 4.04 line A8.9, but excluding exceptional items (RAG 4.04 line A8.8) and any retail operating costs identified in blocks B and C that are not to be funded through the ACTS allowed revenues. With the exception of developer services which is defined in RAG 4.04, individual cost items included in total retail expenditure (such as costs related to billing) have the same definition as the 2011-12 supplementary table definitions for accounting separation guidance. These definitions are subject to the guidance clarifications following the targeted review of cost allocations, which are detailed at the end of this section.

We ask for depreciation separately so we can assess the amount of net margin that we allow to remunerate any future investment in retail assets. Companies should split this figure between depreciation on those retail assets that will continue to be remunerated through the wholesale RCV – that is, those assets that will be in place prior to the start of AMP 6 (April 2015) – and future retail assets that will be remunerated through the household retail price control. Details of any new investments should be provided in commentary.

We ask companies to provide lines on debt management and doubtful debts separately so that we can compare doubtful debt costs across companies. The total operating expenditure line (block A, line 1) includes these costs.

Lines 1, 3, 4 and 5 in block A should all be reported excluding any costs not funded through the ACTS. In particular, block B lines 7 and 10 and all costs in block C should be excluded from costs reported in block A.

The table should be filled out using historic data as far as possible and forecast data for future periods.

Block B asks for information about the costs of water efficiency initiatives and leakage repairs. We need this information so that we can identify how much of this expenditure will be funded through allowed revenues for any wholesale outcome commitments and how much will be funded through the retail service revenue allowed through the ACTS. As an example, a company could put forward a plan to spend £200,000 on water efficiency initiatives. Of this, £50,000 could be for continuing to provide their existing level of water efficiency advice and £150,000 linked to linked to a wholesale outcome commitment.

Collecting the gross expenditure as well as the expenditure funded through wholesale allowed revenues will also provide a cross-check against the relevant wholesale totex that is allowed for under any relevant wholesale outcome commitments. The total operating expenditure line (block A, line 1) excludes operating expenditure relating to demand-side water efficiency and customer-side leak repairs that is not to be funded through the ACTS allowed revenues.

Block C is to allow reporting of any other household retail costs that are not to be funded through the ACTS allowed revenues. Excluded costs set out in this block should be omitted from total operating expenditure, depreciation, debt management and doubtful debt lines (block A, lines 1, 3, 4 and 5). Costs reported as funded through the wholesale control for water efficiency and customer supply pipe leakage repair expenditure (block B) should be excluded from block C. Total operating costs and depreciation for costs excluded from the ACTS should be included in block C.

If companies believe that an adjustment is required to their retail costs, for example to bad debt costs, to take account of factors that meet the three criteria that we have specified in the methodology statement in section 6, they should include the costs to be funded through the adjustment in block C. Any expenditure that will be funded through adjustments would therefore be outside of the ACTS – an adjustment to allowed revenue would, if approved, be made after the ACTS calculation has been made. Where companies do wish to seek such claims they should provide robust and compelling evidence to support them and ensure that the three criteria are met; we set out more detail on this in section 6 of the methodology statement. Any other proposed adjustments should also be included in block C, except for adjustments for metering that are covered by block D.

For example, if a company has bad debt costs of £0.5m and evidence that £0.2m result from factors that meet the three criteria for an adjustment. Of these costs £0.3m should be included in the total cost line in block A and split between the doubtful debt and debt management lines in block A. These costs would be included in the calculation of the ACTS and so may be subject to an efficiency challenge.

The £0.2m for which an adjustment is requested should be included in block C. Evidence supporting the need for an adjustment that demonstrates that the three criteria have been met should be provided. These costs and the supporting evidence would be assessed and if approved, an adjustment would be made to allowed revenues after the ACTS has been calculated.

Total incremental costs over and above allowances under ACTS for outcomes (block Y from table R1) should also be included in block C. Any other costs not funded through the ACTS should be included in block C. A full breakdown of all costs included in block C should be provided in the business plan outside of table R3. This breakdown should provide detail of all cost elements included in the lines for total operating cost and total depreciation (block C, lines13 and 14).

Block D 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. This difference will be used to calculate the adjustment to allowed household retail revenues for metering levels. Similar information has been collected in the past as part of work on tariff differentials through the principal statements. The total operating expenditure line (block A, line 1) is inclusive of these retail metering costs. Companies should also provide commentary in relation to how these costs have been derived.

Block E asks for the number of connected customers in different categories. We will use numbers of customers to calculate the ACTS and the adjustment to allowed revenues for the level of metering.

R4 – information to set non-household average retail revenue per customer

This table collects the information we will use to set average allowed retail revenues per customer to enable the setting of default tariffs.

Block A asks for the retail operating expenditure for non-household retail excluding financing costs.

As with R3, we ask for depreciation separately so we can make a cross check against the amount of net margin that we allow to remunerate future investment in retail assets. Companies should split this figure between depreciation on those retail assets that will continue to be remunerated through the wholesale RCV- that is, those assets that will be in place prior to 1 April 2015 (line 2) – and future retail assets that will be remunerated through the revenue assumed from retail non-household services (line 3).

Block B asks for information about the costs of water efficiency initiatives and leakage repairs incurred by the retail business on behalf of the wholesale 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 recovered from retail non-household revenues. 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 total operating expenditure line (block A, line 1) excludes operating expenditure relating to demand-side water efficiency and customer-side leak repairs that is not to be funded through the ACTS allowed revenues.

Block C asks for costs, charges and charge multipliers relating to the proposed default tariffs.

Line 12 asks for total costs for non-household retail services allocated to each tariff band proposed for 2014-15 and companies will need to carefully consider how these costs should be allocated across different bands and types of customer so as to ensure that they deliver cost reflective charges that are not discriminatory. 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). The sum of all line 12 numbers in the repeated block C will therefore equal the sum of lines 1 and 3 in block A. We will use costs broken down to this tariff band level to assess whether or not the proposed default tariffs from April 2015 imply any undue discrimination or preference between customer groups in different tariff bands.

Line 13 asks for the number of customers per tariff band. This, combined with the charges and charge multipliers, will enable us to calculate average revenues for each tariff band.

Lines 14-18 ask for the retail gross margin components of proposed default tariffs. These components exclude the wholesale charges elements of default tariffs. 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. Any of the charges lines (and associated charge multipliers) can be left blank if not relevant for a particular gross margin component of a default tariff. Similarly companies may wish to add more lines as appropriate. We expect the proposed gross margin components of default tariffs to recover the retail costs allocated to each tariff band (although our average revenue controls will only apply to the average gross margins for each customer class, which may comprise multiple tariff bands within each customer class). Proposed tariffs should be non-discriminatory and so comply with Licence Condition E. They must also be compliant with competition law.

The proposed gross margin components of default tariffs only cover the retail components of end customer charges. The existing structure of tariffs relevant for default tariffs paid by customers should be replicated by combining the gross margin components of default tariffs with proposed wholesale charges for each tariff band. Companies should propose the simplest set of default tariffs (comprising gross margin and wholesale charge components) needed to achieve this that meet the above criteria for non-discrimination.

Lines 19-23 ask for the charge multipliers for each retail gross margin element of the default retail tariffs. The charge multipliers follow the same methodology as specified in our guidance for completing the 2013-14 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. 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 the relevant charges to calculate the revenues that would be recovered by the default tariffs.

Line 24 asks for the projected wholesale charge for each tariff band. This is required so that the working capital requirement for each tariff band can be calculated so that a check can be made that this requirement is covered by the net margin. Line 25 asks for debtor days for each tariff band. These are also needed for the working capital calculations.

Block C should be duplicated completely with the same lines as shown for each proposed default tariff.

R5 – financeability assessment retail margins

This table asks companies for the appropriate net retail margins for their household retail allowed revenues and non-household retail gross margins relevant to default tariffs. It also collects supporting evidence on the components of these net margins.

Block A allows companies to submit a proposed net retail margin for their household retail allowed revenues. We are not prescribing a methodology for calculating this net margin and companies should provide commentary about how and why this net margin has been derived, the methodology used and any assumptions made. Block B asks for information to support the household retail costs remunerated by the element of the net margin that will remunerate working capital (block A, line 1). This information should be consistent with the payment terms guidance we have set out in [ref] in the main statement and any further evidence on this matter provided by the Open Water programme. This information will be used in our assessment of net margins.

Blocks C and D are similar to blocks A and B, but for non-household retail net margins relevant to setting gross margin controls for default tariffs.

Block E allows companies to propose different net margins for different customer classes/default tariff bands. The total net margin contribution to revenue 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. Tariffs should match the tariffs proposed in table R4 block C and lines should be identified by tariff name.

Guidance clarifications for RAG 4.04

The guidance clarifications below are consistent with the existing definitions in RAG 4.04 and with our final definition of retail activities. They provide additional clarity where the targeted review identified that companies had used different interpretations of the activity definitions.

Customer services - network calls

According to RAG 4.04, line A8.1 customer services should include the costs associated with network enquiries and complaints.

The costs of network enquiries and complaints within retail operating costs should include the costs of:

- scheduling jobs where they are triggered by a customer call;
- visiting the customer to investigate the problem; and
- internally generated calls to the retail call centre to enable the customer call to be resolved.

Other operating expenditure

RAG 4.04 provides the following definition for other operating expenditure:

> "Any other operating costs (that is, excluding interest and taxation), on an aggregated basis, including costs associated with the provision of depots and offices, and insurance premiums. Include the costs of (among other costs):
>
> - decision and administration of disconnections and reconnections;
> - demand-side water efficiency initiatives;
> - customer side leaks;
> - other direct costs;
> - general and support expenditure;
> - scientific services; and
> - other business activities."

Scientific services within retail should include all costs of sampling at customer tap (consistent with previous definitions). This is because this activity is customer facing and potentially contestable.

Regulation costs should be split equally across each of the business units for wholesale water, wholesale sewerage and retail. Our previous guidance stated that we considered there to be one retail business unit, four water business units, and four sewerage business units (nine business units in all).

The targeted review found that most companies split regulation costs equally across these nine business units. However, some companies had counted retail as being two distinct business units (household and non-household). We confirm that for the purposes of apportioning regulation costs, companies should first split regulation costs equally across the nine business units (four water, four sewerage, one retail) before then dealing with apportionments of household and non-households in line with the definitions discussed below and the allocation basis specified at the end of this section.

Definition of household and non-household

In response to our methodology consultation and targeted review, one company requested further clarity on the definition of household and non-household for the purposes of separating retail costs. The regulatory accounting guidelines do not include definitions of household and non-household. Our contact with companies suggests that most companies use the definition provided in our 2011 June return reporting requirements chapter 7. However, this differs from the definition in the existing Water Industry Act which is provided in our WSL eligibility guidance.

For the purposes of separating retail costs, we confirm that companies should continue to use the existing regulatory reporting definition below, which was that previously used in the June return:

"**Households**: These are properties used as single domestic dwellings (normally occupied), receiving water for domestic purposes which are not factories, offices or commercial premises. These include cases where a single aggregate bill is issued to cover separate dwellings having individual standing charges. (In some instances the standing charge may be zero). The number of dwellings attracting an individual standing charge and not the number of bills should be counted. Exclude mixed/commercial properties and multiple household properties, for example, blocks of flats having only one standing charge. Where companies issue an assessed charge to a property because metering is not possible or is uneconomic then these properties should be classified as unmeasured.

Examples:

- typical family dwelling, that is, terraced, semi-detached, detached house or flat having individual standing charges; or
- Local authority family dwellings which each have individual standing charges but may be included in an aggregate water bill.

Non-households: These are properties receiving water for domestic purposes but which are not occupied as domestic premises, or where domestic dwellings are combined with other properties, or where properties are in multiple occupation but only have one standing charge. The number of bills should be counted in this case.

Examples:

- industrial/commercial properties (for example, institutions, farms, public houses, offices);
- combined premises with a single standing charge, such as a flat above a shop; or

- block of flats, or caravan site (consisting of multiple dwellings) but only having one standing charge. These must be counted as one non-household property."

Allocation of general and support expenditure to retail

Our targeted review of accounting separation highlighted that different companies use different drivers to allocate general and support costs between retail and wholesale. Our regulatory accounting guidelines allow companies freedom to choose the most appropriate cost driver as long as the differences reflect underlying differences in companies' structure and operations.

However, to enable Ofwat to make consistent comparisons, for the purposes of business plans, companies must allocate general and support expenditure between retail and wholesale on a consistent basis. For the purpose of preparing business plans, we confirm that basis must be the number of full-time equivalent employees engaged in wholesale versus retail activities according to the definitions in this statement, unless the costs are directly attributable either to regulated wholesale or regulated retail services.

Allocation of retail costs between household and non-household

The targeted review also found that companies use different cost drivers then to allocate retail costs between households and non-households. For the purposes of business plans, to enable Ofwat to make comparisons, companies must allocate retail costs between households and non-households based on the number of household and non-household customers, unless the costs are directly attributable either to regulated retail household services or regulated retail non-household services.

Table 4 Retail operating expenditure: differences between business plan reporting requirements and RAG 4.04 definitions

Operating expenditure		RAG 4.04	PR14 business plans
A8.1	Customer services	The costs associated with the following activities. • Billing. • Payment handling, remittance and cash handling.	No change. Business planning guidance clarifies the activities which should be included within network enquiries and complaints.

		• Charitable trust donations. • Vulnerable customer schemes. • Non-network customer enquiries and complaints. • Network customer enquiries and complaints.	
A8.2	Debt management	All costs relating to the management of debt recovery – monitoring of outstanding debt, including issue of reminders and follow up telephone calls, managing and monitoring field recovery of debt, includes costs of customer visits, managing and monitoring external debt collection routes including debt collection agencies and legal, including notification of disconnections to non-household customers.	No change.
A8.3	Doubtful debts	The charge for bad and doubtful debts.	No change.
A8.4	Meter reading	Costs associated with meter reading – including ad hoc read requests, cyclical reading, scheduling, transport, physical reading, reading queries and read processing costs, managing meter data plus supervision and management of meter readers.	No change.
A8.5	Developer services	The operating costs of providing services to developers, to include: • provide developer information – deal with questions from developers where physical aspects of infrastructure are required to change, investigate and advise on implications; and	No change.

		• administration for new connections.	
A8.6	Other operating expenditure	Any other operating costs (that is, excluding interest and taxation), on an aggregated basis, including costs associated with the provision of depots and offices, and insurance premiums. Include the costs of (among other costs): • decision and administration of disconnections and reconnections; • demand-side water efficiency initiatives; • customer side leaks; • other direct costs; • general and support expenditure; • scientific services; and • other business activities.	Excludes costs of demand-side water efficiency initiatives and customer side leaks that are not to be funded through the ACTS allowed revenues. Business planning guidance clarifies the activities which should be included within scientific services. Business planning guidance specifies the allocation basis to be used to allocate general and support expenditure and other business activities to retail.
A8.7	Local authority rates	The cost of local authority rates. This should include both the local authority rates, cumulo rates and sewerage site rates (where appropriate).	No change.
A8.8	Exceptional items	Exceptional items as defined by UKGAAP.	Excluded from retail costs
A8.9	Total operating expenditure excluding third party services	The sum of lines A8.1 to A8.8.	Excludes: • costs of demand-side water efficiency initiatives and customer side leaks that are not to be funded through the ACTS allowed revenues; and • exceptional items.

A5.5 The appointed business

Table 5 Appointee tables at a glance

	Data table	Contents
Summary	A1	Proposed price limits and average bills
Wholesale	A2	Appointee financing
	A3	Wholesale tax
	A4	Network management
	A5	Pensions
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
	A18	Grants and contributions
	A19	Revenue and cost recovery
	A20	Scenarios
	A21	Analysis of debt
	A22	Share capital and dividends
	A23	Debt and interest costs

A5.5.1 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 appointed 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 at the appointed business level – and we will do the same for the impact on total customer bills taking into account the overall outcomes they pay for.

A1 – proposed price limits and average bills

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

Block A asks for the proposed wholesale K factors and revenues for each year. Since there is no wholesale revenue in 2014-15, companies should use a K of 0% in 2015-16 for the water and wastewater wholesale controls (that is, using the 2015-16 wholesale revenues as a base year).

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

In order to meet our statutory duties, including our duty to have regard to the interests of individuals with low incomes, we will evaluate whether companies' proposed total household bills are affordable. To aid in this assessment, companies should provide evidence showing that the proposed total household bills are affordable for customers, including low-income individuals. They should also describe any efforts to mitigate affordability risks, including any social tariff scheme or schemes that currently apply or that they intend to apply during 2015-20.

In addition to this evidence, companies should provide information on the implications of their current spending plans for the affordability of future customers' bills after the current price control period. Several of the tables include information for 2020-25, which will use to examine the impact of choices made at this price review on bills beyond 2020.

A2 – appointee 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 discussed in section 10 in the methodology statement will be calculated by companies' financial projections in this table.

A3 – wholesale tax

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

Allowed 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 the wholesale water and wastewater controls.

For additions in the next 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 they propose to apply to all of the expenditure by service (excluding deductible IRE) for the purposes of deriving allowed revenue for price controls.

A4 – network management and network plus

This table asks companies to make indicative forecasts of the costs that could be incurred in providing us with additional information on network management. Although we have decided not to base allowed revenues on specific cost forecasts in business plans, while we continue to consider the appropriate form and timing of information to be collected in this area, we would still welcome indicative forecasts in business plans, which will help us finalise our proposals for further consultation in this area as set out in section 11 in the main statement.

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 such a first round of questions – we will not be expecting them to provide detailed evidence to explain their responses. An indication of the type of questions we are considering for this purpose is set out in appendix 4 based on our consultation work to date.

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 period progresses, we expect to ask companies to provide 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.

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 split of revenue and cost information within the period 2015-20. As set out in section 11 in the statement we have confirmed our intention to set non-binding sub-limits by 2017-18. We will expect companies to be able to split the relevant information covered in these business planning tables according to our future reporting requirements for both water and wastewater in order to support the development of these sub-limits.

A5 – defined benefit pensions

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

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.

A5.5.2 Financeability

We have a primary duty to ensure that efficient companies can finance their functions. When setting price controls, 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 controls that provide an efficient company the revenues, profits and cash flows that are sufficient to allow it to raise finance on reasonable terms.

This section explains the business plan table information we require to collect to confirm that each company has a financeable business plan in the context of:

- risks being allocated to those best able to manage them; and
- risks being borne by the company and its investors being rewarded at rates commensurate with the risks concerned.

A8 – financial ratios

This table describes the information we require on companies' projected performance against key financial indicators set out in section 10 of the final statement relative to the levels we have determined would be consistent with the maintenance of a comfortable investment grade credit rating, but also asks for the indicator levels that have been used by companies to determine that they will be able to raise debt and equity at rates consistent with the credit rating that they themselves conclude to be appropriate.

This table should be completed on the basis of the ratios:

- that are most applicable to companies' 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 companies assessed their cost of capital in tables W18 and S18.

In calculating the ratios set out in the tables, 'funds from operations' is defined as cash flows from operations excluding working capital movements.

Companies should state which measure of credit rating (that is, name of appropriate credit rating agency) that they are targeting.

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. Under the totex approach we cease to use the construction output price index when setting the price controls for 2015-16 and onwards. We have said that we will index the RCV and wholesale service allowed revenues by RPI.

Published index numbers are provided for each year from 2007-08 to 2012-13.

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 March 2015, with the remaining years from their financial projections.

A18 – grants and contributions

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

A19 – revenue and cost recovery

This table shows the build-up of total appointed revenue by building blocks for wholesale water, wholesale wastewater, household retail, and non-household retail.

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

Operating profit should be the amount projected under regulatory price setting assumptions, rather than on a UKGAAP basis (for example, the pensions allowance will be purely cash-based). But it is this operating profit that we will use to calculate the return on RCV for the wholesale controls.

A20 – scenarios

Table A20 requests scenario information from companies on up to nine scenario pairs. The scenarios test how a company would react to unexpected events or changes in circumstances, which materialise after it provides information relevant to our price controls determinations. The methodology statement explains these scenarios in more detail – and companies do not have to provide information on 'optional' scenarios.

The first three scenarios represent sensitivities of company performance to key wider economic risks. For each of these scenarios, we have included a 'low' and 'high' case.

1. **Household growth (optional).** In this scenario, the number of households is assumed to be either higher or lower than assumed in the base case in the business plan.

2. **Industrial demand (optional).** This scenario varies the level of industrial production.

3. **Cost input inflation (optional).** This scenario focuses on a change in construction output price index (COPI) and industrial electricity retail prices.

The fourth scenario is an **overall economic** scenario. It combines the three scenarios above and also allows companies to incorporate any other impacts arising from a weaker or stronger economy than the assumptions underlying the base case in the business plan. This scenario should also reflect relevant financial risks arising from a weaker or stronger economy, for example elevated debt financing costs.

The fifth scenario is a proposed **rainfall** scenario. To minimise the regulatory burden on companies we propose to analyse one key component of overall weather conditions – the **level** of rainfall. Under this scenario the timing and intensity of rainfall does not differ from the level assumed in the company's business plan.

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, if required. We recommend companies supply us with the results from up to two additional company-specific scenarios; however if there are additional significant company-specific risks which have material impacts on companies and (or) customers, then additional scenarios can be provided.

These further scenarios 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, changes in the availability of credit or to deprivation. Companies must take full ownership of the specification and representation 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 performance levels in the business plan, taking account the structure of the proposed delivery incentives and their contribution to mitigating the risks concerned.

Finally, companies must provide their own combined **overall upside and downside scenarios** based on the full range of relevant risk factors (including any relevant common and company-specific risks), as well as over- and under-performance by the company. In these cases, companies should set out their views as to the totality of the plausible upside and downside risks they face, having incorporated relevant efficient mitigations. Companies must also take ownership of these scenarios and must model the impacts of their combined upside and downside scenarios on bills and returns and provide the results in their business plans.

Table 6 Full list of scenarios

Scenario	Title
Ofwat specified scenarios	
A	Household growth (optional)
B	Industrial demand (optional)
C	Cost input inflation (optional)
D	Overall economic scenario

E	Rainfall
Company specified scenarios	
F	Company-specific scenario 1
G	Company-specific scenario 2
H	Incentive performance variation
I	Overall scenario (economic, rainfall, company-specific risks and incentive performance variation)

Section 9 of the final statement sets out our decision to make:

- scenarios D, E, H and I mandatory; and
- scenarios A, B, C, F and G voluntary.

However companies should provide information on scenarios A, B or C if changes to demand or costs represent a material risk. In addition, if companies seek special regulatory treatment for particular types of costs (for example, in the form of a notified item) we expect them to provide compelling information to support this, including scenario information to demonstrate the potential effects on their expenditure, revenue and incentives.

National base case economic assumptions

So that we can analyse these scenarios consistently and fairly, we said in the business plan methodology that we wanted companies to use common assumptions about underlying national economic conditions. We have sought advice from PwC who recommend using the national base case forecasts set out in the following table. Further information can be found in Economic assumptions for PR14 risk analysis, which we are publishing alongside this document.

Table 7 National base case economic assumptions

Variable	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
GDP (annual % change, real)	1.7	2.1	2.2	2.1	2.2	2.2	2.2
Retail price index (annual % change, nominal)	3.4	3.4	3.5	3.3	3.1	3.1	3.1
Industrial	1.6	1.5	1.4	1.4	1.2	1.2	1.2

production (annual % change, real)							
Unemployment rate (ILO measure)	7.3	6.8	6.6	6.5	6.3	6.0	6.0
Number of households (thousands)	24,446	24,685	24,920	25,154	25,387	25,618	25,848
Industrial electricity retail prices (annual % change, nominal prices)	9.4	9.7	3.4	4.9	4.2	3.9	5.5
Industrial electricity retail prices (annual % change, real prices)	6.0	6.3	-0.1	1.6	1.1	0.8	2.4
Construction output price index (annual % change, nominal)	4.4	4.4	4.5	4.3	4.1	4.1	4.1
Construction output price index (annual % change, real)	1.0	1.0	1.0	1.0	1.0	1.0	1.0

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 companies should explain the assumptions they have used about future rainfall in developing their business plans. Companies should also explain their base case assumptions for scenarios F, G, H and I.

Where relevant, companies should make it clear if their base case forecasts differ materially from the forecasts used for the company's 2013 draft Water Resources Management Plan.

Scenario calibration

We said we would specify the upside and downside cases for each of the first five scenario pairs.

The scenarios are designed to represent realistic high and low cases - they are not intended to reflect extreme possibilities. For this reason we have decided to use P90 and P10 reference points to calibrate the upside and downside cases. This means there is a 10% chance of the key risk factor(s) being higher or lower than the assumptions used for the scenario.

For the **economic** scenarios (scenarios A, B, C and D) we sought advice from PwC who recommend using the following estimates for the upside and downside cases. Further information can be found in Economic assumptions for PR14 risk analysis, which we are publishing alongside this document.

Table 8 Upside case for key economic variables

Variable	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
GDP (annual % change, real)	**2.0**	**3.1**	**3.1**	**3.1**	**3.1**	**2.9**	**2.2**
Percentage point difference from base	(0.3)	(1.0)	(0.9)	(1.0)	(0.9)	(0.7)	(0.0)
Retail price index (annual % change, nominal)	**3.5**	**3.9**	**4.0**	**3.8**	**3.6**	**3.5**	**3.1**
Percentage point difference from base	(0.1)	(0.5)	(0.5)	(0.5)	(0.5)	(0.4)	(0.0)
Industrial production (annual % change, real)	**1.9**	**2.6**	**2.6**	**2.6**	**2.6**	**2.3**	**1.2**
Percentage point difference from base	(0.3)	(1.2)	(1.2)	(1.3)	(1.4)	(1.1)	(0.0)
Unemployment rate (ILO measure)	**7.2**	**6.5**	**5.9**	**5.6**	**5.1**	**4.6**	**4.6**
Percentage point difference from base	(-0.1)	(-0.4)	(-0.6)	(-0.9)	(-1.2)	(-1.4)	(-1.4)
Number of households (thousands)	**24,452**	**24,716**	**24,984**	**25,254**	**25,528**	**25,792**	**26,024**
Percentage deviation from base	(0.0)	(0.1)	(0.3)	(0.4)	(0.6)	(0.7)	(0.7)
Industrial electricity retail prices (annual % change, nominal prices)	**9.8**	**13.6**	**13.6**	**13.6**	**13.6**	**11.5**	**5.5**

Percentage point difference from base	(0.4)	(3.9)	(10.2)	(8.7)	(9.3)	(7.6)	(0.0)
Industrial electricity retail prices (annual % change, real prices)	**6.2**	**9.6**	**9.6**	**9.8**	**10.0**	**8.0**	**2.4**
Percentage point difference from base	(0.3)	(3.4)	(9.7)	(8.2)	(8.8)	(7.2)	(0.0)
Construction output price index (annual % change, nominal)	**4.8**	**6.0**	**6.0**	**6.0**	**6.0**	**5.5**	**4.1**
Percentage point difference from base	(0.4)	(1.6)	(1.5)	(1.7)	(1.9)	(1.4)	(0.0)
Construction output price index (annual % change, real)	**1.3**	**2.1**	**2.0**	**2.2**	**2.4**	**2.0**	**1.0**
Percentage point difference from base	(0.3)	(1.1)	(1.0)	(1.2)	(1.4)	(1.0)	(0.0)

Table 9 Downside case for key economic variables

Variable	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
GDP (annual % change, real)	**1.0**	**-0.8**	**-0.1**	**2.1**	**2.2**	**2.2**	**2.2**
Percentage point difference from base	(-0.7)	(-2.9)	(-2.3)	(0.0)	(0.0)	(0.0)	(0.0)
Retail price index (annual % change, nominal)	**3.0**	**1.8**	**2.2**	**3.3**	**3.1**	**3.1**	**3.1**
Percentage point difference from base	(-0.4)	(-1.6)	(-1.3)	(0.0)	(0.0)	(0.0)	(0.0)
Industrial production (annual % change, real),	**0.3**	**-3.5**	**-2.3**	**1.4**	**1.2**	**1.2**	**1.2**
Percentage point difference from base	(-1.2)	(-5.0)	(-3.7)	(0.0)	(0.0)	(0.0)	(0.0)
Unemployment rate (ILO measure)	**7.5**	**7.9**	**8.3**	**8.2**	**8.0**	**7.7**	**7.7**

Percentage point difference from base	(0.2)	(1.1)	(1.7)	(1.7)	(1.7)	(1.7)	(1.7)
Number of households (thousands)	**24,424**	**24,577**	**24,751**	**24,983**	**25,214**	**25,443**	**25,672**
Percentage deviation from base	(-0.1)	(-0.4)	(-0.7)	(-0.7)	(-0.7)	(-0.7)	(-0.7)
Industrial electricity retail prices (annual % change, nominal prices)	**5.2**	**-4.6**	**-2.2**	**4.9**	**4.2**	**3.9**	**5.5**
Percentage point difference from base	(-4.1)	(-14.3)	(-5.5)	(0.0)	(0.0)	(0.0)	(0.0)
Industrial electricity retail prices (annual % change, real prices)	**2.2**	**-6.4**	**-4.4**	**1.6**	**1.1**	**0.8**	**2.4**
Percentage point difference from base	(-3.7)	(-12.7)	(-4.3)	(0.0)	(0.0)	(0.0)	(0.0)
Construction output price index (annual % change, nominal)	**3.0**	**-1.3**	**0.1**	**4.3**	**4.1**	**4.1**	**4.1**
Percentage point difference from base	(-1.4)	(-5.7)	(-4.3)	(0.0)	(0.0)	(0.0)	(0.0)
Construction output price index (annual % change, real)	**0.0**	**-3.1**	**-2.0**	**1.0**	**1.0**	**1.0**	**1.0**
Percentage point difference from base	(-1.0)	(-4.1)	(-3.0)	(0.0)	(0.0)	(0.0)	(0.0)

Tables 8 and 9 provide the relevant upside and downside cases for the overall economic scenario (scenario D). For the individual economic scenarios (scenarios A, B and C), companies should assume that all other economic variables remain at the levels specified in their base case business plans. So for example, under scenario C (cost input inflation scenario), companies should vary the industrial electricity retail prices and construction output price index using the information in tables 3 and 4, but all other variables should remain at the level specified in their business plan. Further information can be found in Economic assumptions for PR14 risk analysis, which we are publishing alongside this document.

If companies depart from the national base case economic assumptions provided in table 2, then they should calculate the relevant upside and downside case(s) using the relevant percentage or percentage point deviations included in brackets in tables 3 and 4.

For the **rainfall** scenario (scenario E), companies should calculate an upside (downside) case that is 20% higher (lower) than the level of rainfall assumed in its plan **for the financial year 2015-16 only**. For all other years the upside and downside cases should be equal to the base case assumption (that is, the level of rainfall assumed in their plan). These percentage deviations from the base case are consistent with P10 and P90 estimates and are based on our own statistical analysis of levels of rainfall over the period 1980 to 2012.

For the **company-specified scenarios** (scenarios F, G, H and I), companies will need to identify the relevant P10 and P90 reference points and provide estimates for these. They should also explain the base case assumed for the purpose of compiling their base case business plan.

Guidance on completing the tables

Each scenario pair 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 pair, we have specified a standard set of data requirements. The high and low case ask for the same data, but for differing levels of the key variable, for example, in scenario A (household growth scenario) the relevant variable is the number of households.

Unless otherwise specified in the definitions table, 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 efficient management responses to the relevant change in business conditions.

If the change in variable is negative, that is, a decrease relative to the base case, this should be expressed as a negative number. For example, if wholesale water totex decreases by £10m relative to the base case, this should be expressed as minus 10.000, rather than expressed as a change in absolute value of 10.000.

Companies should 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 ODIs are affected under a given scenario and how. The commentary should also describe management responses to the change in business conditions. For scenario I (overall combined scenario) companies should also explain the full range of risks that have been analysed.

Companies should also explain their assumptions on how incentives are calibrated and make clear any assumptions regarding payment of rewards or penalties as well as their SIM ranking in their base case business plans.

For the purpose of completing table A20 so we can consistently compare risks between companies, companies should assume the cost performance (menu) incentive rate is 50% when the ratio of Ofwat's and the company's baseline is equal to 1 in line with our illustration in appendix 1. This does not prevent companies from proposing their own cost performance incentives aligned with their outcome performance commitments and their outcome delivery incentive proposals.

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.

The return on regulatory equity (RORE) is the financial return achieved by shareholders in an appointee during a price control period from its performance under the price control. The return is measured using income and cost definitions contained in the price control framework (as opposed to accounting conventions) and is expressed as a percentage of (share) equity in the business. Importantly, in the calculation the gearing (proportions of share equity and debt financing in the RCV) and cost of debt figures used are those given as the 'assumed' levels in the relevant price control final proposals. RORE can be calculated ex-ante to inform risk and scenario analysis or ex-post to provide an indication of the return achieved by the owners of an appointee which can be compared to the cost of equity originally allowed in the price control settlement and to the return achieved by other appointees on an equivalent basis.

A21 – debt

This table asks companies to provide details of the debt instruments on their balance sheet as at 31 March 2013 analysed between their component parts. This information is to be used to cross check the cost of debt assessment which is made in setting price controls.

Each item of debt on the balance sheet should be classified as fixed rate (block A), floating rate (block B) or index linked (block C).

Alongside each item of debt, a brief description should be included, which should be sufficient to identify the debt instrument uniquely and which in each case should provide the following details:

- the time to maturity,
- the coupon, and for floating rate instruments details of the market index to which the instrument is tied;
- the currency in which the debt is designated (if not in sterling);
- whether the debt is subordinated (class A/class B); and
- any other significant information regarding the structure of the debt which is required to enable the nature of the debt instrument to be fully understood (for example, mezzanine funding).

If the company has interest swap rate instruments, where the swap is not in a designated hedging relationship, the swap should be included in the table by reporting both the paid and received legs separately in the appropriate lines of the table.

Any unamortised debt issuance costs which are included on the balance sheet, and which are being amortised over the period of the debt, should be included in the relevant column.

Debt instruments which are instantly callable should be classified as loans due in less than one year. Inter-company loans should be matched with the relevant instrument at group level at the external borrowing rate. Instruments with no fixed maturity date that are not instantly callable should be reported with a maturity of 25 years.

The real coupon interest rate is the rate associated with index linked debt or for non-index linked debt. It is calculated as the nominal interest rate adjusted for the company's inflation assumption. Rates for borrowings in designated hedging arrangements should be stated as the post hedge interest rate.

The nominal interest cost is the annual interest payable on the outstanding principal at the nominal interest rate, while the cash interest payment is the annual interest based on the actual interest rate paid.

A22 – share capital and dividends

This table contains information regarding the companies' share structure and its anticipated dividend policy which need to be input into the financial model.

The financial model permits companies to apply three methods for calculating ordinary dividends as follows.

1. The growth method – previous year's dividends multiplied by inflation plus real growth. In which case they should complete the opening ordinary dividend figure (line 6) for 2015/16 and the real dividend growth rate (line 8).
2. The distribution method – distributable profit for the year multiplied by percentage distributed. In this case line 9 should be completed.
3. Alternatively, ordinary dividends payable in each year can be entered directly (line 6).

Interim dividends can be set as a proportion of ordinary dividends by inputting a rate into line 11 or can be entered directly into line 10.

A23 – debt and interest

This table collects information about the companies' assumptions regarding the type and level of debt held and the associated interest costs which are reflected in the financial model.

Debt should be categorised as fixed rate, floating rate or index linked.

The interest rates reported for the fixed rate and index linked debt should be the coupon rate (before indexation).

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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Photograph © Stockvault
Printed on 75% minimum de-inked post-consumer waste paper
July 2013

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