



**Setting price limits for 2015-20 – final methodology and expectations for companies’ business plans
Water and sewerage companies briefing session:
questions and answers**

Q1: Is Ofwat planning to publish further guidance, for example on pensions and totex, before business plans are due to be submitted?

- Ofwat does not plan on issuing any further guidance. Now that the methodology statement is published, it is for companies to develop the best possible plan for their customers.
- We have not seen any evidence to support differential treatment of particular costs, so if a company believes there a compelling case then they will need to evidence this in their plan.
- We are considering the possibility of a workshop on average costs to serve (ACTS) and we will publish further information on the proposed timetable for delivering PR14 shortly.

Q2: We would like more information on the detailed risk-based review tests and on the benefits of being an enhanced company.

- The methodology statement sets out how we will approach the risk-based review. To be enhanced a company has to achieve excellence across all four business plan elements (wholesale water, wholesale sewerage, household retail and non-household retail). Performance across the entire plan is what really matters to customers.
- The statement sets out the tests and high level criteria that will be applied and emphasises the importance of Board assurance and past performance. We will not publish the detailed tests because we want companies to focus on developing the best possible plan for their customers rather than focussing on

meeting our tests. Companies will not fail the risk-based review purely due to technicalities in our tests.

- The statement makes it clear that enhanced companies will be better off in the round and will benefit from financial, reputational, procedural and process rewards.
- Investors are very interested in understanding who the high performing companies are and the company's status will provide an objective and transparent measure of this. As certain parts of the value chain are exposed to greater competition this will also provide a useful signal to potential customers. So companies will be able to compete for an excellent reputation with the capital markets and with customers.
- Enhanced companies will also save money from a more straightforward price review process. We are actively considering the possibility of early Final Determinations for these companies.

Q3: How do you envisage the role of the Customer Challenge Groups (CCGs) evolving in the future?

- The CCGs are playing an important role in shifting the emphasis away from the regulator and placing customers at the heart of company's business plans. They have delivered huge benefits already and are driving positive changes in behaviour.
- The CCG reports will be highly valued by Ofwat. We are particularly interested in how well the company has engaged with their customers and how well this customer engagement is reflected in their plan. We expect the CCG to effectively challenge the companies, for example where they are making trade-offs.
- The future role of the CCGs will partly depend on the company's status. For example resubmission companies will require a new CCG report to accompany their resubmitted plan.
- For enhanced companies there will be very little left to do for PR14. These companies could think about how to use their CCG to embed customers' interests in the development of future strategy.

Q4: Company's plans will initially differ to one another in a number of ways. Is it clear where Ofwat might accept differences between companies and where they will substitute the company's estimate with their own?

- We agree that in some cases there may be legitimate differences between companies' plans and in other cases we will need to substitute the company's estimate with our own.
- 'Outcomes' is the area where companies have most discretion and if these are well evidenced and clearly reflect customers' preferences, we do not see why we should substitute the company's proposals with our own.
- If a company is enhanced then we wouldn't substitute the company's totex cost estimates with our own.
- In other areas (e.g. ACTS) we may need to substitute the company's cost with the industry average.
- Companies will propose a cost of capital. If their estimate is not spot on, then we will need to substitute the company's estimate with ours.

Follow up question: What does 'spot on' mean?

- PwC's analysis, published alongside the methodology statement, supports a single cost of capital across the industry.
- If companies think different parts of the industry should have different costs of capital, then they should present compelling evidence to support this in their plans.
- Unless we are presented with compelling evidence we will set a single cost of capital.
- If a company's estimate is materially different to ours, then we will substitute their estimate with our own.
- A company will not fail the risk-based review just because their estimate for the cost of capital is marginally different to ours. But they could fail if their estimate was materially different.

Q5: Will you provide any further guidance on governance and Board assurance?

- The methodology statement provides information on how we are going to assess Board assurance as part of our risk-based review. It is key that Boards own the decisions made in their plans and for companies to explain their governance process.

Q6: We are concerned about losing two months from the original timetable.

- We acknowledge that it is a challenging timetable and we face exactly the same challenges in meeting this as the companies do.
- Despite it being a challenge we are confident the timetable is achievable.

Q7: Is Ofwat hiring consultants to support it in delivering PR14?

- We are entering our busiest period so inevitably we will need more resources than at other times. Rather than employing permanent resources or entering into lots of smaller contracts with consultants we believe it is better value for money to enter into contract with a single delivery partner. All leadership roles within the price review programme will continue to be carried out by permanent Ofwat staff.
- We should be in a position to publish the name of the Delivery Partner shortly.

Q8: Will Ofwat's analysis of categorisation be shared with companies in advance?

- We will not publish the detailed tests in advance because we want companies to focus on developing the best possible plan for their customers rather than focussing on meeting the regulator's tests.
- We are actively considering exactly what information should be provided to companies once the risk-based review is complete.

Q9: What are the benefits of being an enhanced company and what is the difference between standard and resubmission?

- The statement makes it clear that enhanced companies will be better off in the round and will benefit from financial, reputational, procedural and process

rewards. There will be financial rewards but the non-financial rewards are also very important.

- Investors are very interested in understanding who the high performing companies are and the company's status will provide an objective and transparent measure of this. As certain parts of the value chain are exposed to greater competition this will also provide a useful signal to potential customers. So companies will be able to compete for an excellent reputation with the capital markets and with customers.
- Enhanced companies will also save money from a more straightforward price review process. We are actively considering the possibility of early Final Determinations for these companies.
- A standard company is one where we can isolate the problems in their plan that the company can then resolve. This will not be the case for a resubmission company. The only way a resubmission company can truly retain ownership of its plan is for them to resubmit the whole thing.
- There will be reputational disadvantages for a resubmission company. In addition they will not be able to make a menu choice.

Q10: The only surprise in the methodology statement was the increase in notional gearing. What was your thinking on this?

- Compared to other regulators, the evidence base (published by PwC alongside the methodology statement) indicates our previous assumptions on gearing are lower than most other regulators.
- PwC's analysis of the evidence base, which indicates a notional gearing assumption in the range 60% to 70%, should provide companies with enough information to put forward reasonable estimates in their plans.

Ofwat
6 August 2013