Preparing business plans for the 2014 price review – questions and answers

23 September 2013

In 2014-15, we will decide the price and service package (the ‘price controls’) that each of the monopoly water and sewerage and water only companies in England and Wales must deliver in each of the five years between 2015 and 2020.

We recently published ‘Setting price controls for 2015-20 – final methodology and expectations for companies’ business plans’ (our ‘final methodology statement’), which set out:

- our expectations for the information each company should include in its business plan, setting out its proposals for the next five years; and
- how we will review and challenge those plans.

It is important that each company makes sure that the business plan it sends to us by 2 December 2013 is accurate, internally consistent and free from errors.

So, if companies spot mistakes in the business plan tables, supporting guidance or our methodology, or if anything is unclear, they should tell their Portfolio Lead as soon as possible. We will inform all companies of any corrections or clarifications by issuing an information notice or publishing a question and answer document on our website. This is the first of these question and answer documents.

The purpose of this document is to clarify the business plan reporting requirements. Many of the below questions have been helpfully brought to our attention by companies.

Corrections
Question 40 on page 17 was updated on 25 September 2013. Answer to question 40d on page 17 was updated on 30 September 2013.

Outcomes – wholesale

Q1 We assume from the guidance that we only need to complete tables W/S2a for measures/outcomes where we propose a change in service, that is, there is no need to complete the table for measures where we propose stable service – is this correct?

Where an improvement in service results from a statutory quality driver, the change in service level is effectively defined for us – in this instance do we still need to identify the most cost beneficial change in service for one of the alternative service levels?

As we explained on page 13 (third paragraph) of our final methodology, companies should assess, and report on, a number of potential performance levels.

> **"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."**

Where possible we expect companies to do this for all outcomes, including those where the company proposes an enhancement based on customer willingness to pay, those to maintain current levels of service and those where performance commitments are primarily determined by legal obligations. In the case where the company is proposing to maintain service levels this would likely mean including the costs and benefits of a marginal reduction and enhancement in service to demonstrate that maintaining service is the optimal level.

Q2 The guidance for W1 states (appendix 5, page 8): "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". But the guidance for table W3 (appendix 5, page 15, para 1) states: "we do expect that the gross totex described by these tables to equal the totex described by the outcomes table (W1)."

There is an inconsistency in our table W3 guidance – this should say net, not gross, capex.

Costs – wholesale

Q3 The draft methodology indicated there would be three elements to totex revenue requirement:

- a pay as you go (PAYG) %;
- a run-off rate to effectively fund 'depreciation' on the asset existing at 31 March 2015; and
- an average asset life to use when writing down 'new' slow money which enters the RCV from 1 April 2015 as a result of applying the PAYG %.

While the detailed data tables require companies to specify these three variables, the main body of the methodology does not refer to a separate run-off rate on existing assets and an average asset life to write down the 'new' RCV. Instead the paper simply refers to a 'run-off rate' and implies that this would be applied to both the existing and new RCV – for example, in the diagram on page 90.

However, Ofwat also refers to confirming their consultation proposals for PAYG and RCV run-off rates, which may be meant to formulise the two routes to fund existing and new RCV.

Please could you clarify whether the same amortisation rate should be applied to both existing and new assets?

There is no expectation that the depreciation life and the run-off rates should be equal.

Q4 We are expecting that companies will need to propose menu incentive rates for wholesale water and wholesale wastewater. Please can you confirm that you expect the breakeven incentive rates to be in the range proposed by CEPA, that is, 45–50%?

We cannot confirm this. When determining our final position on the calibration of our cost performance incentives we need to know the potential effects these incentives will have on issues like affordability and financeability. So, until we know the company's plans we are in no position to make even an educated guess of these incentive rates.

Q5 Should AMP5 expenditure reported for 2014-15 in the CIS tables S15 and W15 include or exclude transition expenditure identified in tables W3a and S3a?

We have reviewed the information requirements for those expenditure tables that are affected by the inclusion or exclusion of transition expenditure.

We provide additional guidance below which we hope better explains how companies should report transition expenditure consistently within their business plans.

Table	Table title	Year(s)	How companies should report transition expenditure
W3A/S3A	Transition capital expenditure in the water/ wastewater service by purpose	2014-15	Companies should forecast capital expenditure in 2014-15 which represent the costs of the company's transition expenditure.
W1/S1	Outcomes, performance measures and expenditure	2015-16 to 2019-20	Forecasts of totex expenditure should include transition expenditure from 2014-15.
W3/S3	Water/wastewater service expenditure by purpose	2014-15	Forecasts of capital expenditure in 2014-15 should exclude the company's proposed transition expenditure (reported in tables W3A/S3A).
		2015-16 to 2019-20	Forecasts of capital expenditure in years 2015-16 to 2019-20 should include the company's proposed transition expenditure in 2014-15 as this will ensure consistency with the AMP6 totex forecasts in other tables in the business plan.
W3B/S3B	Drinking water quality and environmental obligations – totex	2015-16 to 2019-20	Forecasts of totex should include transition expenditure.
W15/S15	CIS reported and projected actual expenditure for water/ wastewater service	2014-15	Forecasts of capital expenditure in 2014-15 should exclude the proposed transition expenditure as this expenditure is to be omitted from the CIS reconciliation for AMP5.

Q6 In Tables W5 and S5, the note under the table states that the MEAVs should be "in line with a company's regulatory accounts". This suggests that assets under construction (AUC) should be included in the valuations – is this correct? This would be different to the asset inventory in previous price reviews where only commissioned assets were included.

To maintain consistency of reporting with previous asset inventory submissions, the value of 'assets under construction' should be excluded from the 2012-13 MEA valuations in tables W5 and S5.

Q7 The main methodology text (page 41) states, in respect of the single till approach to wholesale revenues and infrastructure charges: "We will set out the detail of these calculations in our draft determinations."

a. If this treatment is not to be confirmed until 2014, what treatment should be applied for the price control proposals set out in company business plans?

It is up to companies to decide on the accounting treatment for connection charges – the wholesale controls allow these to be recognised as revenue or capital contributions.

b. We assume that Ofwat's intention is that infrastructure charge income should form part of recovery of wholesale required income, with the wholesale revenue cap being the residual after netting off other forms of income – is this correct?

Yes, infrastructure charge income should be included in the wholesale controls. We have asked for the capital contributions to be included as a separate line in tables asking about wholesale revenues.

c. If infrastructure and connection charge income is to be treated as part of main income (rather than capital income) should we also assume that all corresponding costs are treated as opex (else risk an inconsistent accounting treatment) – or should we follow our normal accounting treatment for the cost?

Companies should follow whatever accounting treatment they think is right. We are not asking companies to treat infrastructure and connection charges as revenue for statutory reporting, but will simply add this income to revenue from other wholesale charges for the purposes of the wholesale price limits.

Q8 Guidance for revenue in tables W8 and S8 reads: "Revenue forecasts from relevant non-household group, under the proposed wholesale allowed revenues. For all non-households combined, this should sum to W9001/S9001 – the total revenue forecast from wholesale charges." But W9001 and S9001 includes wholesale charges for both household and non-household customers, whereas W8 and S8 relate only to non-household customers. Can you please confirm that this consistency check is in error?

Yes, this is an error and it should say 'for all non-households and households combined'. We are expecting tables W9 and S9 to include all revenue – but this should reconcile to non-household revenues in table W8 (plus household revenue).

Q9 In the table definition for line 2 of table W8, it states that volumes should be consistent with that reported in table W4 (line 36) – but the line definition in table W4 states that it should include meter under-registration and supply pipe leakage, both of which are unbilled volumes (whereas W8 appears to be billed volumes only). Can you confirm that this reconciliation is in error?

Yes, this should say 'be consistent with W4010' – that is, such that it is on a consistent basis with the weighted average demand figures, but not necessarily summing.

Q10 For tables W9 and S9, the company is required to report a wholesale revenue base for 2014-15. In appendix 5 (page 47) the table A1 guidance states a K of 0% should be used for 2015-16. So, are we correct to assume that 2014/5 wholesale revenue recorded in tables W9 and S9 should simply equal our proposed 2015-6 wholesale revenue requirement to ensure K= 0% for 2015-16, regardless of whether or not this correctly represents our actual wholesale revenue for that 2014-15?

Companies can include their wholesale revenue in table W8/S8 if they are able to allocate this. We have said that we will set K=0% in the first year, but we are not expecting the revenues for 2014-15 in tables W8/S8 to necessarily reflect this.

Q11 Please clarify what should be included in Table W5 line 14. Sould it be treatment or distribution assets? Line 12 refers to treated water reservoirs at WTW being reported in line 10. Should this be line 14?

There is a mistake in line 12. It should say:

"The total number of treated water service reservoirs and treated water towers within the water supply system including any secondary disinfection plant on reservoir sites but excluding treated water reservoirs at water treatment works, which should be reported in line 14. Include break pressure tanks."

2010-15 performance adjustments

Q12 We understand from the methodology that the Construction Output Price Index (COPI) will not be applied from 2015-20. AMP6 expenditure is determined and presented in the business plan tables in 2012-13 prices. Will the capex element of the AMP5 forecast spend be assumed to be inflated by RPI or by COPI to cover the period 2012-13 to the end of AMP5?

Legacy forecasts in the CIS will continue to be inflated as described in our communications on the CIS (from January 2013), inflation will be consistently applied across the whole period.

There are only two tables in the business plan that capture data in anything other than constant 2012-13 price terms these are tables W15 and S15.

If other policy models source data from W15 and S15 then they must observe the price base of the source data values and be handled or adjusted to suit those policy models' requirements either within the policy model or as a separate price base conversion process.

The data in W15 and S15 will reflect the company's reported and projected capex (not totex) in the 2010-15 period only. These details coupled with inflation details in table A9 are needed for CIS true-up. Note we prepopulated A9 as much as possible ahead of publishing the business plan tables – data in grey cells is the same for all companies and we are not expecting it to be changed by companies (but we do not stop that from happening).

Q13 The hyperlink in the CIS mechanism tables S15 and W15 refers companies to the CIS Excel spread sheet provided at the 2009 price review (PR09), rather than the later revised version - is this intentional?

No, the hyperlink was incorrect. It should have been a link to the CIS true-up model published in January 2013 – that is,
http://www.ofwat.gov.uk/pricereview/pr14/wholesale/pap_gud201211cistrueup.xlsx

We have corrected the hyperlink on our website.

Q14 In tables W16/S16 line 14 requires the effective tax rate (consistent with table A10 line 18). This would appear to be inappropriate, as the tax effect of a change in the "opex incentive revenue allowance" would be subject to the marginal tax rate, not the average effective tax rate. Also, using the effective tax rate creates an undesirable circularity whereby any revenue allowance identified would itself contribute to the value of the effective tax rate. We propose to input the marginal main corporation tax rate in line 14 of tables W16/S16 – is this correct?

You should ignore the calculation/copy rule that states that the effective tax rate values should equal line 18 of table A10 as this is wrong. Instead, you should enter the effective tax rate figure for 2012-13 in all years in line 14, as reported in your profit and loss account for 2012-13.

We apply the effective tax rate to the outperformance because in the AMP period the actual benefit retained by a company is net of tax. This is the number we include in the incentive allowance and add to the revenue requirement to allow companies to retain the benefit of AMP5 outperformance for five years.

Q15 Does the SIM rewards/penalties of -1% to +0.5% of revenue apply only to revenue recovered from household customers, and not total revenue?

The legacy SIM (for AMP5) will apply to total revenue (including both wholesale and retail revenues and household and non-household revenues). In our final methodology, we indicated that we will use the SIM as a standard minimum national incentive to drive quality of customer service for AMP6. We proposed that SIM scores for 2015-20 should be calculated using data from household customers only, and that we would apply financial incentives to household retail prices in a way that delivers a similar financial outcome to the current SIM. We said that the SIM rewards and penalties for 2015-20 will be applied to:

- the household retail controls in England, and both retail controls in Wales; and
- companies facing the same potential magnitude of financial impact that is in place for the current SIM, but focused within retail controls only.

We also confirmed that we will consult further on our approach to implementing the 2015-20 SIM in September. We will also update SIM scores for year two performance at this time.

Financeability

Q16 The final methodology states: "…we will retain our existing approach to the cost of debt based on forward looking expectations". Please can you confirm that this means you will use the same approach as at PR09 – that is, using a weighted blend of a rate for embedded debt and a rate for new debt?

Unless we are presented compelling evidence we will set a single, notional cost of capital. In assessing the cost of debt component of the cost of capital, we will look at all available evidence. We cannot confirm the exact methodology we will adopt at this stage, we expect companies to propose a cost of capital in their business plans that balances the requirement for companies to be financeable and for bills to be affordable to customers.

Q17 Moody's Special Comment 'Speed of Money Cannot Address Potential Financeability Concerns' of May 2013 said that it would ignore any ratio benefit created by changes in PAYG% or depreciation funding profiles/run-off rates and therefore effectively negate the use of totex levers as a cure for the financeability problem. Will you be taking this into account in your financeability testing?

We are aware of the comments made by Moody's in their Special Comment. We recognise the issues raised by Moody's in this document and we continue to maintain a continuing dialogue with the rating agencies.

In your query, you suggest that the report concludes that Moody's "would ignore any ratio benefit created by changes in PAYG% or depreciation funding profiles/run off rates and therefore effectively negate the use of totex levers as a cure for the financeability problem". But your interpretation is not consistent with the report which concludes the following.

- Any increase in cash flows from a faster pace of cost recovery could reduce external funding pressures, which would be credit positive from a liquidity perspective. However, if the resulting financial flexibility were applied to enhance shareholder distributions at the expense of the economic value of the regulated business and future cash flow generation, a company's leverage could increase notwithstanding the appearance of healthy cash flow-based credit metrics.
- The adoption of totex will increase the potential for misalignment between cost incurrence as reported in a company's financial statements and cost recovery as allowed under the regulatory model. We believe that a faster pace of expenditure recovery may not necessarily correspond to a fundamental improvement in financial strength. We will reflect this view in our evaluation of the credit metrics we use to assess companies' financial performance.

- As a result of Ofwat's adoption of the more sophisticated but also more complex totex methodology, additional disclosure by the companies and/or the regulator will be needed to enable the reconciliation of the accounting and regulatory perspectives on the treatment of expenditure for the purpose of determining whether a regulated business is out-performing or under-performing its expenditure allowances as set by Ofwat.
- Details on how the totex approach for UK water companies will be implemented are still unclear, and hence its overall impact remains uncertain. However, we expect more clarity in further publications over the coming 12 to 18 months, including (1) the regulator's final methodology for setting AMP6 price limits in summer 2013; (2) companies business plans in December 2013; and (3) Ofwat's draft price determination in summer 2014.

We will continue our engagement with Moody's and the other rating agencies as we progress with the delivery of the 2014 price review.

Q18 In table A19 the 'allowed costs' in block D include line 10 "Return on post-2015 totex additions to RCV" and line 12 "Return on 2015 RCV" – hence the operating profit calculated on line 17 appears to exclude the proposed return on RCV. This does not appear to be correct given Ofwat's intention to "use [this] to calculate the return on RCV for the wholesale controls". Should we just input zero against the two "return on RCV" lines in block D?

Ignore line 17 – this should have been deleted from the final version.

Q19 Concerning table A8, line 7: Return on regulatory equity (RORE) (return due to shareholders / equity component of RCV) –we need to use a real cost of debt, in order to achieve RORE of approximately the cost of equity. Should this be calculated using a real, rather than a nominal cost of debt?

Yes, you should use a real cost of debt.

Q20 Concerning table A8, line 8: Cash Interest Cover (funds from operations / net interest) – FFO is operating cashflow less working capital. Should the operating cashflow reflect revenue less fast money, or revenues less opex?

You should use revenue less fast money.

Q21 Concerning table A8, line 10: Funds from operations / net debt – at PR09 this ratio used 'FFO less interest paid' rather than the FFO before interest used in e.g. cash interest cover. Should we continue to use the FFO- less interest as the numerator of this ratio, or just pure FFO?

You should use pure FFO.

Q22 Concerning table A8, line 13: Dividend cover (profit after tax/dividends paid) – should this be in outturn prices (cf A8 line 7)? Outturn prices seems right, as this is the actual constraint on dividends. This will generally be significantly lower than 1, as interest expense is in nominal prices, not real?

Yes, this should be in outturn prices.

Q23 Concerning table A8, line 16: Retained cash flow (RCF) to capex ((funds from operations – dividends paid) / capex) – this is included in the table but not in the description of required ratios in the methodology statement (page 44). Is it a required metric? This metric would normally take interest as well as dividends off the FFO but is not specified to do so. Should interest be deducted?

Moody's definition indicated that this interest should not be deducted, we agree with Moody's definition.

Q24 Concerning table 20: Number of households – is this number of water households or total number of unique households served? The number of water households would appear to be consistent with the water volume information. Defined as number (#), should this be 000s?

Companies need to vary their total number of actual household customers. The 1.3 adjustment factor that we use in the calculation of ACTS does not play a role here.

The answer should be the full number, that is, not in 000s.

Retail

Q25 Could you confirm whether the property numbers requested as part of table R3 Block E should be completed as annual average figures or as year end (31 March) figures. This information is not included in the line definition. While this information was clarified as part of the data collection exercise last October, the definition is not clear in the business plan tables, and there is a risk that different companies may interpret this information differently, which has implications for the ACTS comparisons. Also, please could you make very clear to all companies that the data requested is properties **billed**, which is properties **connected** less **voids**. While this is noted further down in the guidance, some companies may literally interpret block E simply as connected properties (as described), thus including voids.

This is in our view a critical point – any company that makes an interpretation error in this area will affect the whole ACTS calculation (it will affect the average) which, if discovered late, will mean price limit restatements for all companies that have come above the ACTS. I am sure in this comparative area that companies will be checking other companies data, so any errors are likely to come to light at some point.

The definition for customers billed should be the average number of households billed for each customer type within the supply area. Void properties should be excluded.

Q26 In retail businesses the net margin is often expressed after consideration of all costs charged onto customers. Should the retail margin be expressed in these terms or as a percentage of retail only costs?

You should express the retail net margin as a percentage of end retail revenues that is, earnings before interest and tax, EBIT).

Q27 Our assumption based on the final methodology is that average cost to serve will not include any depreciation as this will be fully allocated to wholesale. Is this understanding correct?

The average cost to serve (ACTS) will include depreciation, but we confirmed in the methodology statement that we will apply a single margin rule to ensure that companies do not gain a return on their existing retail assets twice. Table R3 includes lines for the total depreciation of assets included in RCV (assets existing before AMP6) and the total depreciation of assets that are not included in RCV (AMP6 or later assets). These depreciation figures will inform the depreciation allowance included in the ACTS. Depreciation should be included on a current cost basis.

Q28 You have ruled out RPI indexation within retail. There will be some upward pressure on retail costs during the price control period. It would be helpful to discuss how Ofwat envisage the licence term applying. For example, would it be possible to have a different margin each year?

In the methodology statement we said quite clearly that we do not consider that it is appropriate to index retail price controls automatically by RPI. If companies consider that uncontrollable input costs exist then they should submit their retail cost numbers, based on historic costs and separately provide clear and compelling evidence to support their claims that additional costs would be incurred as a result of input price pressures. In the methodology statement we set out three criteria that evidence for any such adjustments would need to meet. If the evidence is persuasive, we will take the risk posed by these costs into account in setting the level of net margin.

Q29 For the non-household retail control can companies build:

- competition losses; or
- margin erosion into their plan?

We explained in our final methodology that we will regulate non-household retail prices by setting average revenue controls that limit charges for non-household retail services for customers in England and Wales (or limits on the average retail revenue per customer for each customer type, that is, the price limits will effectively limit the total amount of revenue that companies can recover from each customer **not** all non-household customers in aggregate). Under average revenue controls, poorly performing companies lose revenue if they lose customers to competitors – providing effective protection for customers and incentivising competition and efficiency.

So the form of the control automatically ensures that companies will lose revenues associated with customers if customers switch to an alternative supplier so there is no need for companies to assume competition losses or otherwise in their business plans and you should assume zero competition losses for the purposes of setting the default tariff.

It is also important to note that a default tariff is a form of backstop protection for customers and in competitive environments it is normal for market participants to offer a range of potential tariffs to customers reflecting their different circumstances. So, companies may wish to offer alternative tariffs outside the default tariff to their customers, but the default tariff reflects a capped price for companies to deliver their regulatory and legislative obligations and must always be offered.

If companies did wish to offer alternative tariffs to customers then they are free to do so either by:

- offering lower prices to customers but continuing to provide all of their regulatory and legislative obligations by not taking up their full price limit under the default tariff; or
- offering additional/higher levels of service beyond those set out in their regulatory or legislative obligations (for which companies could charge). But these additional services would need to be offered outside the regulated business and be subject to the usual transfer pricing and arms-length regulatory protections.

If companies wish to offer a default tariff that is below or declining in relation to their historic costs over the AMP6 period to reflect the challenge of competition then they would have to demonstrate in their business plan how the assumed competition impact has affected any proposed margins. Companies are free to choose whatever means they like to demonstrate this.

Q30 Will default tariffs vary during AMP6? If not, how will tariff changes be accommodated?

Default tariffs are a form of backstop regulatory protection for non-household retail services and these tariffs will not change during the AMP. Companies may wish to offer alternative tariffs to their customers and, if so, they are free to do so either by:

- offering lower prices to customers but continuing to provide all of their regulatory and legislative obligations by not taking up their full price limit under the default tariff; or
- offering additional/higher levels of service beyond those set out in their regulatory or legislative obligations (for which companies could charge). But these additional services would need to be offered outside the regulated business and be subject to the usual transfer pricing and arms-length regulatory protections.

Companies will continue to have flexibility to adjust and amend their wholesale charging.

Q31 Default tariffs are to be expressed as a ‘gross margin’, but the tables only appear to accommodate revenue to be recovered from each customer group. As such, where in the plan are default tariffs to be represented as a % gross margin?

The non-household retail control refers to average retail revenue per customer which is equal to a ‘gross margin’ that is made up of two components:

- non-household retail costs; and
- non-household retail net margin.

These two elements combined comprise the 'gross margin' (or the default tariff), which is added to the wholesale charge to calculate the total tariff (wholesale plus retail) for non-household customers. So, in these tables companies should include their gross retail margins as costs plus the net margin.

Q32 Are we correct to assume that required tariff rebalancing (for example, site area concession) cannot be rebalanced within the retail control, and would have to be performed within the structure of wholesale charges?

We will address this issue in our charging consultation in October.

Q33 Do we calculate default tariffs using forecast or historic costs?

The methodology statement explained that prices for 2015-20 will be set on historic costs, using data from 2013-14. But because the data on 2013-14 will not be available when plans are submitted in December 2013, it will effectively be a forecast of this year that we will scrutinise for cost allocation issues and compare with previous years as part of our risk-based review tests.

Q34 The statement says that companies should wait for Open Water to provide an assumption for non-household payment terms (in late October). This would confirm a change to our plan very late in our internal governance process.

While we recognise the timing challenges, we believe that it is important that the payment terms question is answered by market participants and not Ofwat. The original response from Open Water was not sufficiently detailed to define these payment terms entirely and it appears to have been difficult to reach agreement on the key payment in arrears/advance question among the various participants. The October deadline in the methodology statement is a long-stop deadline and we have offered support to the Open Water programme to assist in resolving this issue as quickly as possible and ideally ahead of this deadline. If companies are keen for an early resolution of this issue then we would suggest that they could similarly offer support to the Open Water programme to address this issue.

Q35 Should companies make the same assumption for household payment terms as for non-household?

Yes – companies should assume the same terms between household retail and wholesale and non-household retail and wholesale.

Q36 The final methodology statement (section 6.3.4) says the proposed three-year glidepath results in companies above the average cost to serve (ACTS) meeting the ACTS target in 2018-19. But the example provided in appendix 2 implies that the glidepath is only two years, with the ACTS target met by 2017-18.

A three year glide-path from the first year of AMP6 (which is 2015-16, that is, beginning in April 2015) would result in companies' cost to serve falling to the average level by April 2018 – that is, for the 2018-19 financial/charging year companies would be expected to reach the ACTS target and would get no more revenue in their price limits than the ACTS target.

Q37 The new household total revenue control is a revenue cap – as such, are we correct to assume that tariff rebalancing (for example, for social tariffs, vulnerable group tariffs) can now be delivered purely within the retail control?

We will address this issue in our charging consultation in October. In the meantime, existing UK Government guidance on social tariffs published by Defra relating to companies operating wholly or mainly in England states that: "it would be inappropriate for non-households to contribute to the funding of social tariffs in the longer term".

Q38 Tables R3 and R4 require IFRS depreciation back to 2010-11. Given that historic depreciation has been reported on UK GAAP basis, should we provide equivalent IFRS-based figures on a best endeavours basis?

You should report this on the same basis used for AMP5 (that is, UK GAAP) so it is reconcilable to the regulatory accounts.

Q39 For the depreciation lines on tables R3 and R4, the notes suggest that this should only include tangible fixed assets. We presume that this is incorrect, given that software (for example, billing systems) is intangible, and forms a large part of the depreciable expense of our retail operations.

Intangible assets (for example, software or billing systems developed in-house) should be included.

Appointee tables – general information

In the original business plan guidance we advised that 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 unless otherwise specified in individual tables. However for tables A3 (Wholesale tax), A8 (Financial ratios), A10 (Income statement), A11 (Balance sheet), A12 (Trade receivables), A14 (Cashflow) , A15

(Fixed Assets), A22 (Share capital and dividends) and table A23 (Debt and interest costs) we now request that companies input financial information for forecast data on a nominal price basis, with the following exceptions:

- For table A8 complete section B on a nominal price basis except for lines 6 and 7
- For section A of table A8 we request that companies confirm the price base that they have used.
- For table A22 line 8 (real dividend growth) we still need this to be input as a real dividend growth rate

Appointee tables – wholesale

Q40 Concerning table A2 – line 7: (question updated on 25 September 2013)

a. Is this using actual or nominal capital structure?

Actual.

b. Is this interest expense or cash expense?

Expense.

c. How should intercompany loan interest income be treated?

Ignore intercompany loan interest and any associated dividend.

d. Should calculations be done in real or nominal terms?

Real (question updated on 30 September 2013).

Q41 Concerning table A2, lines 8 and 9:

a. Is the company's operating profit actual operating profit, or the 'regulatory' version (that is, using fast money instead of opex and the CCD instead of HCD)? We think it should probably be the regulatory version (that is, as in table A19).

In A2 use your accounting operating profit.

b. What are the true-ups for – for example – RCV and CIS (that is, not the rewards/penalties)? Should these also be included as allowed costs?

These are not allowed costs.

c. In the table A19 calculation of operating profit includes operating income as an allowed cost. Why is this an allowed cost? Does that mean it's also included within the allowed revenue?

It is not an allowed cost.

d. Should the working capital revenue allowance also be an allowed cost?

There is no allowance for working capital adjustment for PR14.

Q42 In appendix 5 of the final methodology, the guidance for table A3 states that: "Companies do not need to separate the 'brought forward' pools in block A". But the table requests that companies report just such a separation – how does Ofwat propose companies perform this separation given that capital allowance pools are not split on this basis, or is the table in error?

Companies should separate and populate the tables as presented.

Appointee tables – price limits and average bills

Q43 The calculation on line 13 in table A1 is incorrect – it picks up line 5 (water K) rather than line 8 (average water wholesale bill). Will the table be reissued, or should we correct the calculation?

Please simply correct the calculation.

Q44 The calculation of 'average retail bills – household' in block C of table A1 is incorrect. It takes total retail income and divides it by the number of water service customers for line 11, and then the same total divided by sewerage customers for line 12. This would act to incorrectly allocate the bill impact of the retail control between water and sewerage. We assume that the correct method would be to divide retail income by the customer count used in the ACTS calculation, and then re-allocate it to water and sewerage customers by counting single served customers as 1, and dual service customers as half of the factor applied to dual service customers (proposed as 1.3 in the methodology statement). As such, the formula for the bill impact on (say) water customers of the retail control should be:

$$\frac{Total\ Retail\ Revenue}{(Water\ only + Sewerage\ only + 1.3 * Dual\ service)} * (Water\ only + 0.65 * Dual\ service)$$

We assume that we should correct the table, particularly if (as part of our plan) we propose an alternative multiplier for dual service customers in the ACTS calculation. Is this correct?

We are happy with any allocation method of arriving at 'average retail household components' that gives average total bills. This should, though, be consistent with any proposals in the retail tables.

Appointee tables – financeability

Q45 The calculation rule for table A11 line 8 (Current assets, Trade and other receivables) requires it to match table A12 line 14 (HH unmeasured trade debtors, measured in days). We assume that this should read that table A11 line 8 should equal table 12 line 9 plus line 13 – is this correct?

Yes – table A11 line 8 should equal table 12 line 9 plus line 13.

Managing risk

Q46 We note that Ofwat have signalled that IDoKs will remain an important risk mitigation element in the regulatory framework. Do you consider that the potential adoption of private water connections should be included in the list of IDoK items?

We have not made decisions on what might be included in the list of potential notified items. As explained in our final methodology paper, we expect companies to explain how they have analysed, mitigated and managed risk in their business plan proposals.