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

18 October 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. As part of the 2014 price review process (PR14) the companies are now preparing their business plans, which will set out their proposals for the next five years. They will submit these to us by 2 December 2013.

In 'IN 13/07: 2014 price review communications between Ofwat and water companies', we set out our approach for engaging with water companies and other key stakeholders during the 2014 price review. As of 1 October the price review has entered the restricted communication phase. During this phase Ofwat will only respond to business plan queries if we feel it is appropriate. If this is the case then we will make our responses to these queries available to all companies.

We recently published our first question and answer document to clarify the business plan reporting requirements. This second question and answer document presents queries and answers received by Ofwat during the restricted communications phase for the benefit of all companies.

Water efficiency

Q1 Concerning block B operating expenditure – part funded through wholesale

a. For baseline service water efficiency (BSWE) – we assume baseline service incurred in 2013-14 is all retail funded and included in the ACTS calculation. Is this correct?

In 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans', we stated that our view is that water efficiency services and demand-side leaks should be carried out by the retail business, with a role for the wholesale business to fund and incentivise the retail business.

Baseline service water efficiency (BSWE) incurred in 2013-14 should be funded through retail and included in the ACTS calculation.

b. For the sustainable economic level of water efficiency (SELWE) – we assume all wholesale expenditure funded in AMP6, whether incurred in 2013-14 or not, is not part of the ACTS calculation. Is this correct?

It is up to companies to decide where other expenditure on water efficiency sits between wholesale and retail. However, this should be consistent across AMP5 and AMP6. For example, SELWE expenditure is reported in R3 block B, line 7 for AMP5 and any equivalent expenditure in AMP6 should also be included in this line.

c. For costs part funded through wholesale (lines 5 and 8) – we assume these amounts should be included in the total wholesale operating expenditure in wholesale table W3 (block B, line 21)?

Expenditure funded through wholesale (R3 block B, lines 7 and 10) should be included in total wholesale operating expenditure.

The construction output price index (COPI)

Q2. Generic queries regarding revised values for COPI

We are aware that the Office of National Statistics is replacing the COPI index it publishes on its website. However, this is not the source we use. We use the statistics produced by BCIS under contract to BIS.

As indicated in the more information section in 'IN 12/10: Changes to COPI' you can go to the BIS website for the statistics, where they are available free of charge.

We understand that BIS will continue the current 2005 COPI indices for at least another year. BIS will be consulting users over the coming year about improvements to methodology, and currently has no plans to follow the ONS and move from constant volume to chained volume measures. Should this change we will notify companies.

Revenue correction mechanism (RCM)

Q3. The revenue correction mechanism (RCM) model on the Ofwat website calculates the net present value at 2012-13 prices by indexing from 2007-08 prices by applying the final determination RPI. We believe that it should index by actual RPI. Could Ofwat review the way that its model is working and confirm whether this is the correct position.

The RCM spread sheet that is available on the Ofwat website was updated to fix an error in December 2011 to replace the original version that we released in May 2011. We told companies about this in 'IN 12/08: The capital incentive scheme (CIS) and the revenue correction mechanism (RCM) – frequently asked questions'. However, we recognise that this updated version contains another error. While we are certain that this error does not continue into the PR14 financial model, we think that it would be useful to publish another updated RCM spread sheet to correct for the error on our website.

We have changed the file so that we inflate to 2012-13 prices using actual RPI before it works out an annualised amount to adjust the PR14 revenue requirement in the financial model.

You can access the updated RCM spread sheet on our website.

Back billing (table W17, line 7)

Q4. The definition requires that to make a claim for back billing it would have to have back billed and have received all outstanding amounts due from the customer. This appears to be a new requirement and is not a condition set out in the Ofwat document 'Simplifying the revenue correction mechanism: supporting information'. In our view companies' revenue would include the amount billed and should therefore form the basis for the correction and not be restricted to the amount actually collected.

This definition is a clarification of what is required that was not clear in previously published documents.

After we published 'IN 11/04: Simplifying the revenue correction mechanism', we received a number of clarification requests from companies about the RCM model. We decided to include in regulatory accounting guideline (RAG) 4.04 some line definitions in the regulatory accounts tables to clarify certain areas. This then formed the basis for the line requirements in the business plan tables.

The back-billing incentive is an additional incentive for companies to identify properties that have been charged less than they should have been. We expect companies to take a reasonable, fair and appropriate approach for the back-billed amounts that they are claiming. Therefore, we would expect companies to claim the amounts that reflect what has been back billed and received from the customer. If a company is unable to back bill a property, it will not receive a benefit.

Historic abstractions above the abstraction incentive mechanism (AIM) threshold

Q5. We are required to complete lines for the abstraction incentive mechanism (AIM). However, we have not had the river reaches and associated company abstraction sources on which to base the AIM assessments specified by Ofwat or the Environment Agency. Without this information we cannot undertake the analysis or complete the tables.

We are working with the Environment Agency to try to provide a list to each company of the surface and groundwater abstraction sites that should be reported on in table W7 on the AIM. We are planning on providing a list to each company soon.

We are not planning to provide companies with the impacts of groundwater abstractions between water bodies or the historic flow data for the surface water bodies affected. Companies should ask for this information directly from their regional Environment Agency offices. You should wait until you receive the list of abstraction sites before asking the regional Environment Agency offices for the additional information.

Bankside storage facilities

Q6. Please can you confirm where bankside storage assets should be reported – should this be line 1 or line 6 of table W7?

The table guidance suggests bankside storage assets should be included in line 1. However the RAGs seem to suggest that raw water storage assets between the abstraction point and the treatment works should be included as raw water distribution assets rather than water resources assets.

To maintain consistency of reporting with previous asset inventory submissions, bankside storage assets should be reported in line 1.

Return on RCV

Q7. In the previous question and answer document, for Q41 Ofwat suggests using 'accounting operating profit'. We presume that is the current cost operating profit (that is, after CCD).

It is the historical cost accounting profit per IFRS or FRS102. This will not be strictly comparable to the WACC but will be comparable to your financial statements post-2015.

Working capital adjustments

Q8. The answer to Q41d (concerning table A2) of the question and answer document updated on 30 September says that Ofwat will make no allowance for working capital adjustments at PR14, but other business plan tables (for example, A13) do make reference to working capital. Does the answer to Q41d only apply to table A2 (the table the set of questions refers to) or does it apply to all tables?

The answer to Q41d is correct – there is no specific allowance for working capital adjustment for PR14 as there was for the 2009 price review. Working capital balances will be used in our financial model though, hence the other references to working capital in the business plan tables.

Retail and wholesale cost allocation

Q9. What method should be used to allocate general and support expenditure between retail and wholesale costs?

In relation to general and support expenditure, 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans. Appendix 5: Guidance on business plan tables' (page 43) says:

> "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**."

Examples of 'directly attributable' costs would include insurance premiums which relate only to the retail business, where no apportionment or proxy is required to attribute the costs between wholesale and retail. However, where claims history is used as a proxy to apportion the insurance costs between wholesale and retail, we would not consider this to be directly attributable and should therefore be allocated based on number of full-time equivalent employees engaged in wholesale versus retail activities.

Q10. Table A8 asks for the expected levels of financial ratios. Please confirm whether these should be presented pre or post any adjustments for legacy incentives.

Table A8 should be presented **post any midnight adjustment for the RCV but pre any revenue impact of legacy incentives**. However, it would be helpful to have commentary on the subsequent impact on the financial ratios of any adjustments to revenue resulting from legacy incentives.