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

2 December 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 the companies have been preparing their business plans, which set out their proposals for the next five years. They are submitting 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 we said Ofwat would 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 have published a number of question and answer documents on our website. We have continued to receive a small number of questions up and until very recently, which are summarised in this document. This was made available to companies between 25 and 29 November 2013.

Business plan tables W2 and S2

Q1 If we proposed a delivery incentive that measures average performance over five years, could we merge cells in business plan table W2 and S2?

On page 9 of 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans. Appendix 5: Guidance on business plan tables' we state that "companies should consider the frequency with which performance will be measured, as well as the frequency that associated delivery incentives will be applied". Companies may propose that some performance

commitments are measured and incentivised annually, whereas others may only be assessed in a future year, such that successful delivery can be determined. In these situations performance commitments should be entered into tables W/S/R2 consistent with the year(s) assessment will occur and incentives will apply.

In other cases, performance may be assessed annually but the incentive would be based on average performance over a number of years. In this instance the company may decide it appropriate to include the average level of performance in each year as performance is being assessed in each year. Alternatively, the company may feel it more appropriate to concentrate on the year when overall performance is to be determined, such that it is more consistent with the application of the incentive. In these cases it is for the company to decide the appropriate way to enter this data in tables W/S/R2 and to set out the approach clearly in its business plan.

Financial model

Q2 Our financial model has been developed for us by a consultancy and the only way to smooth bills is to change our PAYG ratio in each year of the period. We have input all of our data and we have achieved what we want in terms of average prices over 2015-20. We understand that we should only input one PAYG ratio into the data tables that we will be submitting to Ofwat, but note that this will produce a different result in Ofwat's model in terms of the profile of prices (and financial ratios) than we will be presenting in our plan. Will the fact that we are changing our PAYG ratio in each year cause an issue for Ofwat?

No, the fact you are changing your PAYG ratio in each year in your plan and model will not cause an issue for us. We note that there are a number of tools available to companies to smooth expenditure profiles. We will expect you to include one PAYG value in the data table, and to explain your variable approach in the commentary to table W10 and provide evidence to justify your approach.

Pensions

Q3 On pensions we note that although we have allocated a very similar proportion to the average company to retail for pension deficits our percentage allocated to water and sewerage is very different.

This is not surprising and is likely to be caused by the fact that our sewerage business is twice the size of our water business.

We think that using your average allocation would mean our water customers inappropriately subsidising our sewerage customers so we propose to continue to use our own allocation. Do let us know if you think is the wrong approach.

Also on pension deficits there does not appear to be a line within the retail tables to account for cash items that are neither operating expenditure nor depreciation.

We presume we should add the recovery of pension deficits to our default tariffs on non-household retail and allow an imbalance between costs and revenues in the tables.

In household retail we assume that pension deficits are not part of the ACTS calculation and we will therefore add the value to line 13 (opex excluded from the ACTS).

Do let us know if we are wrong in any of our assumptions.

We used company specific splits to split pension deficit costs post efficiency challenge between water and wastewater. The numbers in table 3 of 'IN 13/17: Treatment of companies' pension deficit repair costs at the 2014 price review' for the water and sewerage split are the water and sewerage company (WaSC) average when the company specific split costs are aggregated, not the industry average we applied to all WaSCs.

Our approach is intended to set price control allowances on a proportionate basis across all companies. Of course you can propose whatever approach it deems appropriate to deal with any pension deficits – but you should not expect that we will necessarily change our approach to setting price controls.

For retail we agree with your proposed approach to dealing with pension deficit costs in retail cost tables.

For the household retail controls, pension deficits will not form part of the ACTS calculation, as our allowance for these costs already includes an efficiency challenge. On the household side we will therefore add in relevant amounts to companies' household revenue allowances after the ACTS calculation (as we will do for any other adjustments that we allow) and companies should include these costs in line 13 of the retail tables (opex excluded from ACTS).

For non-household retail controls, pension deficits should form part of companies' default tariff proposals.

Cost of capital

Q4 The guidance on business plan tables (appendix 5 page 27) says:

> **"Companies should provide this [the weighted average cost of capital, or WACC] 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."**

Do we within this:

- assume an embedded debt at an assumed industry level or our own. The cost of debt would therefore be a weighting of embedded rates and current market rates depending on structure; or
- assume a structure with no embedded debt such that this 'notional' company was securing all its debt today. This would produce a lower cost of debt. This is what at least one of our members thought was said at the meeting.

As per the Ofwat guidance the gearing for a notional company would be between 60% and 70%.

When establishing a WACC for a notionally efficient company the cost of debt should reflect the cost of both embedded debt and any new debt that the company needs to raise. The level of embedded debt should reflect the position of an efficient company within the industry and will not necessarily reflect the company's own position.

Companies need not assume that they secure all their debt today.

Company December presentation meetings

Q5 – Who will be attending companies December presentations from Ofwat?

The December meetings will be attended by a combination of Executive and Non-executive Directors and members of the Portfolio team.

Information concerning the Environmental Improvement Unit Charge (EIUC)

In 'Setting price controls for 2015-20 – final methodology and expectations for companies' business plans' (our 'methodology statement'), which we published in July 2013, we committed to the inclusion of companies' efficient expenditure to resolve sustainable abstraction issues as part of the PR14 process (including in relation to schemes to tackle RSA sites). In line with this process, and the business planning guidelines we have set out, we would expect water companies to have identified economic and efficient investment for sustainable abstraction issues within their business plans and to have discussed proposals with their customer challenge groups (CCGs). The Environment Agency will continue to be closely involved in these discussions as part of its membership of the CCGs.

We will consider these business plan proposals as part of our risk-based review and price review process, and will then be consulting on our draft determinations in line with our PR14 timetable.

We can also confirm that water companies are able to consider sustainable abstraction proposals as part of the transition investment mechanism, should they consider it appropriate to start to tackle these sustainability issues in 2014-15. Again, we set out our approach to transition investment proposals in our methodology statement.

The Environment Agency has recently indicated that it will no longer need the EIUC funding for these sustainable schemes if efficient funding could instead be secured through the price review process. The Environment Agency has said that it does not anticipate charging water companies for EIUC for quarter 4 of 2013-14 and for 2014-15.

Taken together, we consider that these actions ensure business plans can be prepared and reviewed on a consistent basis for all companies in anticipation of the Water Bill, without having to make assumptions about adjustments to address the risks of double counting. We feel this would this is a really important step to take, as it will provide clarity for the water companies about how best to present this information as part of the development of their business plans and give greater transparency and confidence to the sector over how we will be addressing sustainable abstraction expenditure in the forthcoming price review.

If the Water Bill does not withdraw or amend Section 61 of the Water Resources Act 1991, then we can confirm that we commit to work with the Environment Agency and Defra before we make appropriate adjustments to PR14 price controls to take such developments into account, to ensure efficient funding if the EIUC were instead to remain in place. This is in line with our general approach to the Water Bill in undertaking the price review process – we have explained in our methodology statement that price controls will need to accommodate such changes, if appropriate.