March 2014

Setting price controls for 2015-20 – pre-qualification decisions

OFWAT

Correction
Table 3 on page 10 was updated on 10 March 2014.

Overview

In our final methodology statement ('Setting price controls for 2015-20 – final methodology and expectations for companies' business plans', published in July 2013), we explained we would carry out a risk-based review of the companies' business plans. This document summarises the results of that review.

All water and wastewater companies in England and Wales have worked hard to engage with their customers and to take ownership of their plans. While the business plans of other companies demonstrated areas of strength, against our necessarily high bar, only South West Water and Affinity Water have pre-qualified for enhanced status – we are confident their plans will deliver the best possible outcome for customers.

In the document below, we:

- explain our approach to the risk-based review;
- highlight the exceptional practices we have identified across the water sector;
- explain the features of South West Water's and Affinity Water's business plans which led to our pre-qualification decision;
- explain the decisions and process for South West Water and Affinity Water;
- set out the benefits that enhanced companies will receive;
- set out our proposals for the operation of the service incentive mechanism (SIM) to assist pre-qualifying companies in their decision making; and
- explain a change to our plan for the delivery of the 2014 price review (PR14), which will allow some other companies the opportunity of an earlier draft determination.

Ahead of our published timetable for PR14, we have completed a risk-based review of company business plans.

In our final methodology statement, we explained we would deliver a proportionate price setting process, which put an assessment of companies' business plans at the heart of the price setting process. At the end of this process, we said that we would categorise the companies' business plans. Companies with business plans which met our high standards would be categorised as enhanced. A company's categorisation will determine which process it needs to follow to complete the price review in 2014, as well as the reward package that it will receive.

We explained that our risk-based review process would contain tests for high quality in four areas.

- **Outcomes** – the company's key proposed deliverables for consumers, including current and future customers and the environment, and the incentives associated with delivering them.
- **Costs** – the costs, for both wholesale and retail businesses, associated with delivering the company's proposed outcomes.
- **Risk and reward** – how the company's proposals balance risk and the rewards for bearing those risks between consumers, including current and future customers and the environment, and the company and its investors.
- **Affordability and financeability** – the impact of the company's proposals on customers' bills, and its ability to finance its functions.

We received companies' business plans in early December 2013. Following our initial testing of the companies' views on risk and reward, it was clear that these were not in alignment with market evidence. Later in December, we issued an information bulletin (IB 28/13, 'Change to Ofwat's price review process') which outlined that we would be providing a further opportunity for companies to secure the best possible outcome for customers. On 27 January 2014, we published further guidance on risk and reward ('Setting price controls for 2015-20 – risk and reward guidance'). We wanted to provide the companies with the opportunity to ensure that the balance of risk and reward they faced was right and set in the context of changing market evidence.

Given that we asked companies to reconsider the risk and reward components of their plans, we did not further assess these components of their business plans. As a result, our assessment of company business plans has focused on the:

- **outcomes** to be delivered for customers;
- **costs** of delivering these outcomes;
- **affordability** of overall plans for customers;
- **companies performance in 2010-15**; and
- quality of **Board assurance** to support plans.

These tests have allowed us to assess whether company business plans will deliver the services customers want, in an efficient way, at prices they can afford.

Overall, we have been able to identify a range of exceptional practices across

the different elements of companies' business plans.

All water and wastewater companies have worked hard to take ownership of their plans. We have seen a real change in approach, which will benefit customers. It is clear that companies have engaged actively with customers, and have sought to reflect that engagement in formulating customer-focused plans. The customer challenge groups (CCGs) have made a significant and important contribution to this step change.

Table 1 below provides examples of the exceptional practices we have identified across the industry. We set out more detail in appendix 2. We have a duty to be transparent as part of the principles of better regulation. In addition, transparency is important to deliver the incentive properties of the risk-based review process. It also:

- provides clear signals to investors and other stakeholders about the quality of companies' business plans;
- promotes accountability and public trust; and
- provides valuable information to customers and other stakeholders.

Therefore, we are, and will be, publishing in detail the findings of our risk-based review as this will facilitate our carrying out of this element of the price review process.

Table 1 Examples of the exceptional practices across the industry

Test area	Examples of exceptional practices
Outcomes	Evidence of an effective engagement process with customers and wider stakeholders, including using representative samples of customers and evidence that the results from engagement fed into the business planning process. Inclusion of long-term performance commitments measures. Consideration of whole life cost options in setting performance commitments.
Costs	A clear 'needs' case for expenditure, accompanied by evidence that the company had: • considered a range of options; • benchmarked costs; and • sought third party assurance where appropriate.

Test area	Examples of exceptional practices
Affordability	An iterative approach to developing the business plan with multiple rounds of customer engagement enabling the company to develop its plan in line with customer expectations. Explicit engagement with 'hard to reach' customers. Development of innovative and effective measures to assist customers with affordability concerns. Customer engagement on the long-term affordability of the business plan and reflecting their preferences in the future bill profile.
Board assurance	Strong board interaction with appropriately focused third-party assurance providers. Clear and comprehensive explanation of the process that the board has followed to assure itself that the business plan is of high quality
Companies' performance in 2010-15	Clear and full account of the extent to which the company had met their obligations under the previous price control, as well as following our methodology for calculating adjustments.

While the business plans of other companies demonstrated areas of strength, against our necessarily high bar, only South West Water and Affinity Water have pre-qualified for enhanced status. Some highlights of these two companies' plans are set out in table 2.

Table 2 Plan highlights for South West Water and Affinity Water

Company	Plan highlights
South West Water	Strong focus on engagement and balancing the need to keep customers' bills affordable while also investing in the environment and service improvements. Engagement programme running for two years across two phases – understanding its customers' priorities and then presenting them with investment and bill options from which to choose. Responding to customer acceptability of proposed bill increases by scaling back investment in some areas and challenging itself further on efficiency. A comprehensive range of schemes in place to support customers' who would find its proposals difficult to afford, including a social tariff put in place in 2013-14. A focus on affordability and efficiency, through the use of:

Company	Plan highlights
	• new technology; • partnership working; and • innovative approaches. Working in partnership with other parties to pursue low-cost sustainable solutions for: • improving water quality; • managing flood risk; and • improving the resilience of its service. Delivering proposed improvements to its retail service at no additional cost to its customers and absorbing cost increases through efficiency savings. A pledge to share the benefits of success fairly between customers and investors through an independently monitored and transparent performance sharing framework called 'WaterShare'. Meeting expectations in relation to Board assurance of the plan.
Affinity Water	Identifying major challenges the company faces, in particular a supply demand deficit, and using the results of its engagement with both customers and the wider consumer interest to shape its proposed solutions. Engaging with its customers and providing convincing evidence that its plan is affordable, and clearly acknowledging the impact of the Thames Tideway Tunnel on acceptability of combined water and wastewater bills. Working with its CCG to agree proposals to address this – that is, a comprehensive communication programme to inform customers of potential price changes and taking steps to mitigate the impact on vulnerable and low-income customers. Convincing evidence that its wholesale plan is efficient. Proposing to deliver efficiencies in retail costs to offset any increase in input price pressure. An innovative company plan and vision – for example, reporting performance at a community level as well as at a company level. Convincing evidence that its Board has provided strategic direction and leadership as well as convincing evidence of how the Board assured itself that the plan was of high quality.

These companies must now decide whether to accept our risk and reward guidance and to address a limited number of actions we have identified which we consider can be addressed within the timetable for draft determinations for enhanced companies. The actions we are asking South West Water and Affinity Water to complete are set out in appendix 3. By completing these actions, these two companies have the opportunity to deliver plans that will deliver the best possible outcome for customers.

In April 2014, enhanced companies will receive financial, procedural and reputational benefits

A company will be enhanced if it:

- is pre-qualified;
- accepts our risk and reward guidance;
- takes the limited actions that we have identified; and
- remains affordable and financeable.

It will then receive:

- **reputational benefits** – our assessment provides a clear signal to investors and other stakeholders to allow them to identify those companies that we consider have high-quality plans;
- **procedural benefits** – enhanced companies will receive an early draft determination;
- **financial benefits –** enhanced plans will benefit from an initial financial award and have access to enhanced cost performance menus reflecting the benefits of high quality business plans to current and future customers; and
- An enhanced company will also receive the **protection of our 'do no harm' approach** – we will amend enhanced companies' allowed returns in line with any upward adjustment for other companies if there is a substantial shift in capital markets or other unexpected event which means that the risk and reward package needs to increase.

The scale of the financial benefits for the enhanced companies is set out further below in table 3 and appendix 4.

We set out our proposals for the operation of the service incentive mechanism to assist pre-qualifying companies in their decision making.

The benefits that enhanced companies receive are in additional to the service incentive mechanism (SIM). The SIM encourages companies to:

- provide high-quality customer service;
- reduce customer complaints; and
- get things right first time.

We set out our proposals, including the financial benefits of SIM, in table 3 below.

We will not seek to distinguish between non-enhanced companies through our risk-based review.

In our final methodology statement, we said we would categorise non-enhanced companies as either ‘standard’ or ‘resubmission’. However, based on the evidence available to us now, we no longer consider it appropriate to put companies into separate standard and resubmission categories.

- In general, all of the companies who did not pre-qualify for enhanced status will need to work with their CCGs.
- In the absence of further evidence, we consider there is no objective basis for distinguishing between companies that did not pre-qualify for enhanced status.

In light of this, all companies not pre-qualified for enhanced status will be classified within a single category.

Companies that have not pre-qualified must re-submit their business plans by 27 June 2014. Companies that choose to submit new evidence by 2 May 2014 will be considered for an earlier draft determination on 25 June 2014.

We will need to have further dialogue with the non-enhanced companies to improve our understanding of their plans before we can discharge our duty to ensure that customers’ interests have been protected.

We are proposing changes to our plan for the delivery of PR14 which will allow some other companies the opportunity of an earlier draft determination.

Companies that have not pre-qualified must re-submit their business plans by 27 June 2014.

However, we consider that some of the companies may be in a position to submit amended business plans earlier than 27 June 2014, allowing us to make an earlier draft determination for such companies. We consider such companies would benefit from reputational and some procedural benefits. Accordingly, all non pre-qualified companies have the opportunity to ask for a draft determination by June 2014.

For a company to ask us to make a June determination it will need to be satisfied that it has reviewed and addressed the areas for further work that have been identified and would need to submit new evidence by **2 May 2014**. We request that companies confirm their intention to submit a plan for a June determination by 17 April 2014. More information on our approach to this June determination will be published on 4 April 2013.

These plans would still need to pass a high bar – we will need to be confident that they can form the basis of draft determinations without further regulatory intervention, consistent with our duties and the decisions set out in our methodology statement. We will assess requests for early determinations on this basis. Where companies requesting early draft determinations meet the high standard we expect, we would issue determinations for them on 25 June.

To assist companies to meet this accelerated timetable, we will be providing further information on wholesale cost thresholds and publishing our wholesale cost models on 4 April. We will also be providing further feedback and information on specific areas of business plans, including:

- outcome delivery incentives;
- retail cost allocation;
- adjustments for companies' performance in 2010-15; and
- our approach to default tariffs.

Companies that request, and are accepted for, a June draft determination will not receive the financial benefits available for enhanced status, as this was intended to reward those companies whose plans were of sufficiently high quality that they did not need substantive revision. But these companies will see some reputational and procedural benefit.

Although we are explicitly asking pre-qualifying companies to confirm whether they will adopt the risk and reward guidance, we expect all companies to take it into account for their plans. We also expect all to engage with their CCGs and to provide a Board assurance of their business plans.

Table 3 summarises our decisions and approach to the key points outlined above. Further detail is provided in the appendices.

Table 3 Summary of key decisions and approach

Key point	Summary of approach	Further information
We have assessed business plans using the risk-based review tests we set out in our final methodology statement	Our risk-based review tests provide a robust and consistent way to assess the quality of company business plans. Our tests focus on the key areas that drive the level of service provided to customers and the cost of providing those services. In determining which companies are pre-qualified for enhanced status we have, as we explained in IB 28/13, focused our assessment more narrowly on our risk-based review tests for: • outcomes; • costs; • affordability; • Board assurance; and • companies' performance in 2010-15. Based on these tests, we have now categorised each company as pre-qualifying, or not pre-qualifying, for enhanced status.	Appendix 1 – Our approach to the risk based review
We set out the key themes and high-level results from our assessment of business plans	The results of our risk-based review tests for all water and wastewater companies show areas of excellence, with active engagement with customers and clear Board ownership evident in companies' business plans. How companies have 'scored' against our risk-based review tests reflect that in some areas we need further dialogue with the companies to understand their business plan proposals, including in fundamental areas such as outcomes and costs. These test 'scores' are set out, at a high level, in this document.	Appendix 2 – Overview of our assessment of companies' business plans
We explain the decisions and	Key conclusions from the results of our risk-based review tests for South West Water	Appendix 3 –

Key point	Summary of approach	Further information
process for the prequalified companies	and Affinity Water and the process that these companies will now need to follow and the actions that they will need to complete in order to be enhanced.	Decisions and process for pre-qualified companies
We outline the rewards for enhanced companies to assist pre-qualified companies to consider our invitation to accept our risk and reward guidance	Companies that gain enhanced status will be identifiable to investors and other stakeholders as companies that have high-quality business plans. As well as this clear reputational benefit, we are offering enhanced companies the opportunity to benefit significantly from: • an initial award of £11 million to South West Water and £4 million to Affinity Water (reflecting the scale of the two companies) and recognising the benefits to current and future customers from high quality business plans. We invite both companies to propose how this award is recovered over time in net present value neutral manner taking account of the interests of present and future customers; • [Sentence amended 10 March 2014.] an incentive package with a menu that is different to the menu we will offer other companies, with higher rates for both under- and overperformance (a symmetric menu) and a cost sharing rate that is 5% higher than the menu for other companies. The scale of benefit will depend on a number of factors, and could be worth an additional £6 million for South West Water and £3 million for Affinity Water; and • an early draft determination, accompanied by our 'do no harm' principle, which ensures that enhanced companies will not be any worse off for being categorised as enhanced and receiving an early draft determination. In broad terms, the combined effect of the initial award and enhanced incentive package could amount to around £17 million for South West Water and £7 million for Affinity Water.	Appendix 4 – Benefits for enhanced companies

Key point	Summary of approach	Further information
We outline our approach to the SIM for 2010-15 and 2015-20.	The SIM for 2010-15 will be based on three-year average SIM scores for both qualitative and quantitative measures (each contributing 50%). The maximum reward for highly performing companies is capped at 0.5% of revenue of the appointed company's integrated business; the maximum penalty is capped at 1% of revenue. SIM rewards and penalties will form part of the draft determination for each company, and we will be asking all companies to provide final SIM information on 2 May. Companies will have the opportunity to make representations to us before we make our final determinations, though the process will differ slightly for enhanced companies which receive their draft determinations on 30 April. SIM for 2015-20 will be similar in structure and form to the current incentive, but with more weight on qualitative versus quantitative measures (qualitative measures will now contribute 75% to the overall SIM score). Continuing with a similar structure and form will continue to drive improvements in less well performing companies.	Appendix 5 – Service incentive mechanism (SIM) for 2010-15 and 2015-20
We clarify the key milestones in the price control process following the risk-based review	South West Water and Affinity Water will now follow the process outlined for pre-qualified companies in our risk and reward guidance. By 10.00 am on 17 March, they will need to respond to our invitation to accept our risk and reward package, as well as carry out additional actions in a small number of areas in their business plans. We will then decide if either of these companies should become enhanced, through having adopted all aspects of our risk and reward guidance and continuing to pass the risk-based review tests used for pre-qualification. If they become enhanced, they will receive a draft determination on 30 April. The risk-based review is now concluded for all other companies. We are offering these companies an additional opportunity to receive an earlier draft determination in June rather than in August, if they can address our feedback on their business plans earlier.	Appendix 6 – Process for other companies

Key point	Summary of approach	Further information
	Companies that elect for a June draft determination will need to notify us by 17 April and submit new evidence and their revised business plans by 2 May. Companies that elect for an August draft determination will need to submit their revised business plans on 27 June. We will be publishing detailed information and feedback on all company business plans on 4 April. This feedback will help companies to adjust their business plans ahead of draft determinations, though we expect companies to continue to engage actively with their customers and take ownership of business plan revisions. We will publish final determinations for all companies on 12 December 2014.	

List of appendices

Appendix 1: Our approach to the risk-based review

On 2 December 2013, each water and wastewater company and water only company in England and Wales submitted five-year business plans to us. In our final methodology statement, we said that we wanted companies to:

- take ownership for submitting high-quality business plans with a coherent narrative, based on sound reasoning and containing proportionate evidence;
- submit plans that were cost efficient, containing accurate projections and estimates;
- base plans on the findings of good-quality engagement with customers, focusing on things customers value; and
- ensure the plans as a whole were at a cost that customers found acceptable.

High-quality business plans provide stakeholders with confidence that companies:

- understand their needs;
- will deliver on their promises; and
- provide value for money.

This helps to build customer legitimacy. Customer legitimacy builds trust between companies and their customers, which is important to help ensure companies can meet the challenges that the water sector faces, such as climate change and population growth.

To encourage high-quality plans, we introduced a new phase to the price setting process – **the risk-based review** – to assess the quality of company business plans. We said that we would publish our views on the quality of each business plan and that very high-quality plans would benefit from financial, procedural and reputational incentives.

The results of the risk-based review are a step towards final determination of price controls in December 2014.

In our final methodology statement, we explained that the risk-based review of business plans would be the first step in our price review process.

We said we would assess plans both at an overall level and at a price control, or element, level. That is, we said we would assess the quality of a company's business plan across each binding price control for **wholesale water**, **wholesale wastewater**, **household retail** and **non-household retail activities**.

We said we would assess business plans in a robust and consistent way. We explained our assessment of the quality of a company's plan would focus on those key areas that drive the level of service provided to customers and the cost of providing those services.

- **Outcomes** – the company's key proposed deliverables for consumers, including current and future customers and the environment, and the incentives associated with delivering them.
- **Costs** – the costs, both for wholesale and retail businesses, associated with delivering the company's proposed outcomes.
- **Risk and reward** – how the company's proposals balance risk and the rewards for bearing those risks between consumers, including current and future customers and the environment, and the company and its investors.
- **Affordability and financeability** – the impact of the company's proposals on customers' bills, and its ability to finance its functions. In contrast to outcomes, costs and risk and reward, this is assessed at a whole company level.

We also said we would assess plans against the following **'other considerations'**.

- **Board assurance** – the extent to which the company's Board provided assurance that the business plan is of high quality. This is assessed at a whole company level.
- **Companies' performance in 2010-15** – both to determine how differences between actual and expected performance should be reflected in prices for 2015-20, but also because some aspects of past performance are relevant to the credibility of a company's plans. This is assessed within the wholesale water and wastewater elements of the plan.

In determining which companies are pre-qualified for enhanced status we have, as we explained in IB28/13, focused our assessment on:

- outcomes;
- costs;
- affordability;
- Board assurance; and
- companies' performance in 2010-15.

Table 4 below summarises our tests in these areas and the corresponding assessment criteria (and are the same as set out in our final methodology statement). The areas not tested for pre-qualification are presented in grey.

Table 4 Summary of risk based review tests

Area	Risk-based review test	Assessment criteria
Outcomes	Customer engagement and willingness to pay (WTP) evidence	1.1 To what extent has the company demonstrated an effective customer engagement process?
		1.2 To what extent has the company demonstrated effective engagement with wider consumer interest, including environmental interests, generally and through their CCG?
		1.3 How far has the company demonstrated a robust approach to gathering WTP information and in mapping this to its outcomes, performance commitments, and outcome delivery incentives?
	Performance commitments	2.1 How clearly and appropriately has the company allocated its outcome commitments between its separate controls (household retail, wholesale water and, where relevant, wholesale wastewater)?
		2.2 How consistent are the company's proposed commitments with requirements specified in our methodology, including in relation to SIM, AIM, and leakage?
		2.3 To what degree has the company given adequate assurance that its performance commitments are consistent with Defra's and (or) Welsh Government's Statement of Obligations, relevant statutory requirements and licence obligations?
		2.4 How reasonable are the company's assumptions in relation to areas of anticipated statutory requirements and (or) environmental programme that remain uncertain?
		2.5 How well do the company's proposed commitments reflect value for money, and how reasonable are the costs?
		2.6 How strong is the evidence that the company has provided in relation to its previous track record of

Area	Risk-based review test	Assessment criteria
		delivery in relation to performance commitments and to what degree does this support its commitments for the future? To what extent has the company properly justified any changes in proposed performance levels?
		2.7 How well has the company demonstrated that its proposed outcome commitments are consistent with the interests of consumers in the longer term (in particular, that its activities and outcomes will be economic and efficient in the longer term)?
		2.8 How clearly has the company demonstrated that the proposed commitments can be measured and recorded consistently and that they will have the appropriate governance and quality assurance processes in place to ensure that the proposed performance commitments will be based on robust data?
	Outcome delivery incentives	3.1 To what extent do the proposed incentives conform to the framework specified in our methodology?
		3.2 How well do the proposed incentives represent an appropriate balance of risk between companies and customers?
		3.3 How consistent are the company's proposed ODIs with consumers' interests and with customers being appropriately compensated for any under-delivery of performance commitments?
		3.4 To what extent do the company's ODIs take properly into account its assumptions on other regulatory incentives, including totex efficiency sharing and any incentives or penalties it proposes associated with the wider statutory frameworks within which it operates?
Costs	Wholesale cost assessment	4.1 How consistent are the company's proposed costs with our view of an efficient company?
		4.2 To what extent has the company provided sufficiently persuasive evidence in relation to its costs such that we decide that it is appropriate to either modify our approach to the modelling of costs, or, that it is appropriate make specific changes to the cost corridors/thresholds for the company concerned?

Area	Risk-based review test	Assessment criteria
Costs	Retail cost allocation	5.1 How clearly and appropriately has the company allocated current and historic costs, including between wholesale and retail, and between household and non-household retail?
	ACTS adjustment	6.1 To what extent has the company provided sufficient evidence to show ACTS has been adjusted on the basis set out in this statement and to support any other company proposals for adjusting the industry ACTS, including that any proposed adjustment relates to a factor that: • has a material impact on their costs; • is beyond efficient management control (having taken all possible steps to control it); and • impacts the company in a materially different way to other companies?
	Default tariffs	7.1 How well do the company's proposed default tariffs ensure it recovers no more than appropriate proportion of its allowed costs and net margin?
		7.2 How adequate is the company's assurance that its proposed default tariffs do not unduly discriminate between customers in a given customer class or between customer classes? We will have a particular focus on the evidence that smaller non-household customers are not subject to undue discriminatory tariffs.
Risk and reward	Risk analysis	8.1 How far has the company provided sufficient information – including on company-specific risks – for us to analyse the impact of risks on consumers and companies?
		8.2 To what degree are the companies' proposed risk impacts within plausible and acceptable ranges?
	Level and allocation of risk	9.1 To what extent do the different commitments and incentives within the price control elements of the business plan involve an efficient level and allocation of risk?
		9.2 In deriving these proposed allocations, has the company made appropriate assumptions in relation to the efficient mitigation of risk?

Area	Risk-based review test	Assessment criteria
	Rewards and returns	10.1 How well do the returns assumed in the company's business plan provide rewards to the company (and its investors) that are appropriate to the relevant risks the company is bearing for each element of its plan?
	Retail net margins	11.1 Has the company proposed a reasonable household retail net margin?
		11.2 Has the company proposed a reasonable non-household retail net margin?
Financeability and affordability	Financeability	12.1 Taking account of assumptions on costs, revenues, risks and capital structures, how clear is it that the company, if efficient, will be able to finance its functions?
		12.2 How clearly do the company's proposals for each control allow sufficient returns to be self-financing, if it is efficient, over the longer term?
		12.3 To what degree do the company's proposals represent a fair balance between the company and customers?
	Affordability	13.1 How well has the company demonstrated that its proposals are affordable over 2015-20 and that it has used appropriate means to secure the affordability of bills for customers?
		13.2 How clear is it that the company's proposals are affordable in the longer term? How far has the company demonstrated that it has explored all possible options to ensure that this is the case, for example, by the way it has set out its cost recovery proposals?
Other consid-erations	Adjustments to 2015-20 price controls	14.1 How clear is it that the company has calculated any adjustments to 2015-20 price controls in line with our guidance and tools?
		14.2 How fairly do the company's proposed adjustments to 2015-20 price controls reflect its performance in 2010-15?
	Board	15.1a To what extent has the company's Board provided

Area	Risk-based review test	Assessment criteria
	assurance of a high quality business plan	assurance that the business plan is of high quality?
		15.1b Is the assurance that the Board has given supported by data and evidence from elsewhere in the plan?
		15.2 To what extent has the company's Board given adequate assurance that its outcomes are consistent with Defra's and(or) Welsh Government's Statement of Obligations, relevant statutory requirements and licence obligations?

In light of these tests, we have assessed company business plans and categorised each company. We explained in the overview that based on the evidence provided in plans we decided that we would no longer categorise companies as 'enhanced', 'standard or 'resubmission'. Instead, based on our assessment against the risk based review tests companies are classified as:

- **pre-qualifying for enhanced** – based on the areas assessed, a company is on course to be enhanced. A pre-qualified company needs to consider whether to adopt our risk and reward guidance published in January and resolve the actions we have identified. Our final assessment will reflect the company's response to the risk and reward guidance; or
- **other companies** – based on the areas assessed, a company is not enhanced. These other companies will have the opportunity to provide further information and evidence on their plans, and if appropriate, to make adjustments to their plans ahead of draft determinations. As set out in the overview, once companies have reviewed their plans in light of our assessment, they can submit their business plans and any new evidence by 2 May and ask to receive a draft determination in June 2014. Alternatively, they could choose to submit their plan by 27 June and receive its draft determination in August 2014.

The risk-based review process is only one step towards making final determinations of price controls. Once a company has received it draft determination (at a time subject to the process described above) we will make our final determination for all companies in December 2014. There will be a period of consultation in which all stakeholders will be able to comment on each company's draft determination.

We set out our overview of assessment of plans in appendix 2.

Appendix 2: Overview of our assessment of companies' business plans

We have a duty to be transparent as part of the principles of better regulation. In addition, transparency is important to deliver the incentive properties of the risk based review process. It also:

- provides clear signals to investors and other stakeholders about the quality of companies' business plans;
- promotes accountability and public trust; and
- provides valuable information to customers and other stakeholders.

Therefore, we are, and will be, publishing in detail the findings of our risk-based review as this will facilitate our carrying out of this element of the price review process.

In this appendix, we set out the key themes and headline results for each of the key assessment areas relevant to our pre-qualification decision – that is:

- outcomes;
- costs;
- affordability;
- Board assurance; and
- adjustments to 2015-20 price controls (that is, adjustments for companies' performance in 2010-15).

Our risk-based review indicates many encouraging signs of progress – particularly in the way that companies are engaging with customers to deliver plans that reflect their priorities. Table 5 below highlights how companies have delivered high-quality proposals in these areas.

Table 5 Summary of exceptional practices

Test area	Examples of exceptional practices
Outcomes	Evidence of an effective engagement process with customers and wider stakeholders, including the use of representative samples of customers and evidence that the results from engagement fed into the business planning process. Evidence of a robust and balanced approach for addressing uncertain statutory requirements and the National Environmental Programmes when formulating their proposals on performance commitments. Inclusion of long-term performance commitments measures. Consideration of whole life cost options in setting performance commitments.
Costs	A clear 'needs' case for expenditure, accompanied by evidence that the company had considered a range of options, had benchmarked costs and had sought third party assurance where appropriate.
Affordability	An iterative approach to developing the business plan with multiple rounds of customer engagement enabling the company to develop its plan in line with customer expectations. Explicit engagement with 'hard to reach' customers. Development of innovative and effective measures to assist customers with affordability concerns. Customer engagement on the long-term affordability of the business plan and reflecting their preferences in the future bill profile.
Board assurance	Strong Board interaction with appropriately focused third-party assurance providers. Clear and comprehensive explanation of the process that the board has followed to assure itself that the business plan is of high quality.
Companies' performance in 2010-15	Clear and full account of the extent to which the company had met their obligations under the previous price control, as well as following our methodology for calculating adjustments.

More information on how companies have performed against our risk-based review tests in these areas is set out in the summary sheets below.

Table 6 Mapping summary sheets to test areas

Test area	Mapping to summary sheets
Outcomes	Pages 26 and 27 summarise our assessment of customer engagement and willingness to pay information and performance commitments.
Costs	Page 28 sets out our assessment of wholesale costs. Page 29 sets out our assessment of retail cost allocation. Page 30 sets out our assessment of average cost to serve (ACTS) adjustments.
Affordability	Page 31 sets out our assessment of affordability in 2015-20 and affordability beyond 2020.
Board assurance	Page 32 describes how companies have provided assurance that the business plan is of high quality and sets out how we have tested for this during the risk-based review.
Adjustments to 2010-15 price controls	Page 33 describes our assessment of how companies have treated differences between actual and expected performance in 2010-15.

A2.1 Interpreting the test information presented on the summary sheets

We provide test summary sheets below, which relate to each area we have tested for pre-qualification. They are intended to provide context to our assessment and allow companies and their stakeholders to understand broadly how business plans performed against our risk-based review tests.

We used a **four-point scale** to score companies' business plans against our tests and 'other considerations'. We carried out a detailed assessment process, scoring each assessment criterion individually, and then assigning an overall score for each test. In most cases, we carried out separate tests for each element of companies' business plans (household retail, non-household retail, water wholesale and wastewater wholesale), but in some cases we applied the tests at a whole company level.

We explain the four possible test scores below.

- **A** – where a company has demonstrated that it is **exceeding stakeholders' expectations** and overall we consider that the evidence put forward is exceptional.
- **B** – where a company has demonstrated that it is has robustly addressed stakeholder's expectations, and we have received **sufficient and convincing evidence** to support companies' proposals.
- **C** – at this stage, we do **not** have sufficient and convincing evidence. More information is required for us to understand companies' proposals or to give us confidence that companies' will deliver proposals that protect customers interests.
- **D** – at this stage, substantially more information is required for us to understand companies' proposals and to give us confidence that companies' will deliver proposals which protect customers interests.

In some cases, our assessment has highlighted areas of companies' business plans where we do not have sufficient and convincing evidence at this stage: in these areas we have assigned C or D test scores. We want to emphasise that this does not necessarily mean we will require companies to adjust these areas of their business plans. In some cases, we expect that companies will be able to provide further evidence or information to give us confidence that their proposals are aligned with consumer interests and will be delivered efficiently.

In particular, page 28 provides specific information on the wholesale cost thresholds we have used for the risk based review. For clarity, these cost thresholds do not represent the baselines that we will use when setting the price control. In the case of some of these cost items, companies did not provide sufficient and convincing evidence for us to assess the costs through our risk-based review. It would be wrong to conclude that a gap between the thresholds we have used for the risk-based review and the company's business plan costs implies either that the company is inefficient or that we will ultimately disallow any of the costs put forward by the company. Gaps between our thresholds and company cost projections highlight areas where there are opportunities for the companies to provide further information and evidence. There are still opportunities for the companies to make representations before we use the thresholds to set the price control.

Our assessment of companies' business plans indicates many encouraging signs of progress – particularly in the way that companies are engaging with customers to deliver plans that reflect their priorities. This appendix sets out the key themes and headline results from our assessment. It is intended to provide context to our assessment and allow companies and their stakeholders to understand broadly how business plans performed against our risk-based review tests. We will provide more detailed information and feedback on companies' performance against our tests on 4 April.

A2.2 Interpreting the company abbreviations

We have used abbreviations for the companies throughout this appendix. These are set out below.

Table 7 Company abbreviations

Water and wastewater companies		Water only companies	
Anglian Water	ANH	Affinity Water	AFW
Dŵr Cymru Welsh Water	WSH	Bristol Water	BRL
Northumbrian Water	NES	Dee Valley Water	DVW
Severn Trent Water	SVT	Portsmouth Water	PRT
South West Water	SWT	Sembcorp Bournemouth Water	SBW
Southern Water	SRN	South East Water	SEW
Thames Water	TMS	South Staffs Water	SSC
United Utilities	UU	Sutton & East Surrey Water	SES
Wessex Water	WSX		
Yorkshire Water	YKY		

Summary of risk-based review test

Outcomes is one of the key innovations in PR14 when compared with PR09. The tests focus on two key aspects: how companies have engaged with their customers and how the results of this engagement are reflected in the proposed business plans and specific performance commitments (PCs).

Why assess outcomes?

Outcomes (for example, delivering customers clean and safe water) are a key building block of the PR14 methodology. Companies' proposals in this area need to be assessed to ensure that customers are being listened to and that customers' interests are protected. Companies were required to provide evidence on what customers are willing to pay (WTP) for and how this is used to shape the companies' proposed plans. As the proposed outcomes and PCs can cover any area of activity, the testing has broad coverage and covers a number of assessment criteria.

How does the test work?

The test on customer engagement considers the quality and breadth of engagement, dialogue with other regulators, and whether robust evidence has been developed and used throughout the plan. The test on PCs includes four checks applied at plan/element level. It also includes three in-depth analytical tests applied to individual PCs, and a further check on how companies plan to measure and assure their performance. The results of the overall tests are summarised in the graphs alongside. The table summarises the results of the in-depth analytical tests.

Below we highlight examples of exceptional aspects of business plans, as well as areas for improvement.

Examples of exceptional practice

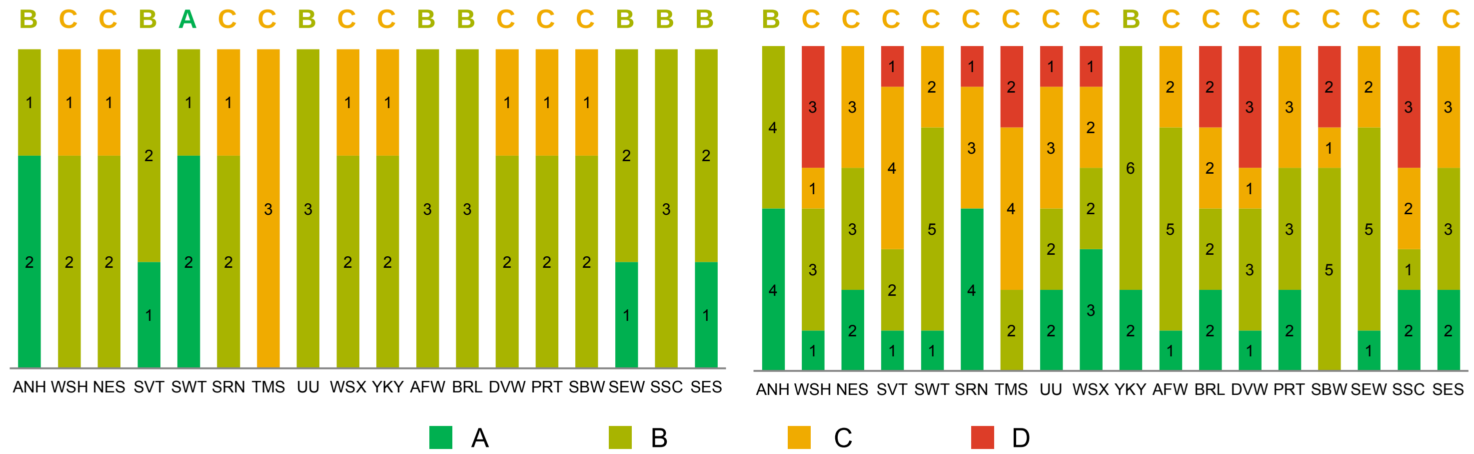
Comprehensive programmes of customer engagement covering well constructed samples of different customer types, with several iterative stages.
Strong scrutiny and challenge from CCGs, with clear evidence that companies have listened and acted on feedback, resulting in tangible changes to plans.
Robust evidence on WTP, with clear links to proposed levels of service and evidence on why these represent value for money (VFM) for customers.
Packages of PCs that provide broad coverage, focus on specific issues of interest or concern, or areas of emerging innovation (for example, water usage).

Examples where additional evidence or improvement is required

Unconvincing explanation of thread between willingness to pay estimates and proposed outcomes and PCs.
Insufficient evidence that proposed commitments represent value for money (for example, that the performance level is the most cost beneficial compared with alternatives).
PCs that imply deterioration from current service levels without explanation as to why this is in customers' interests, or instances where customer willingness to pay for selected service enhancements have been excluded from plans without explanation.
Missing or unconvincing evidence on how proposed levels of performance are related to past performance, or how the performance metrics are defined.

Outcomes tests results within the wholesale water element of company business plans

Test 1 Customer engagement and WTP results **Test 2 Performance commitments results**



These graphs show the number of each score (A through D) each company has attained for the tests.

Key test results

Companies have embraced the importance of customer engagement and worked closely with CCGs. Most plans performed well against our tests for customer engagement and WTP information. Evidence on how WTP estimates were used to shape details of plan is less convincing for some companies. However, overall, results show a significant step forward in the sector's approach to regulation.

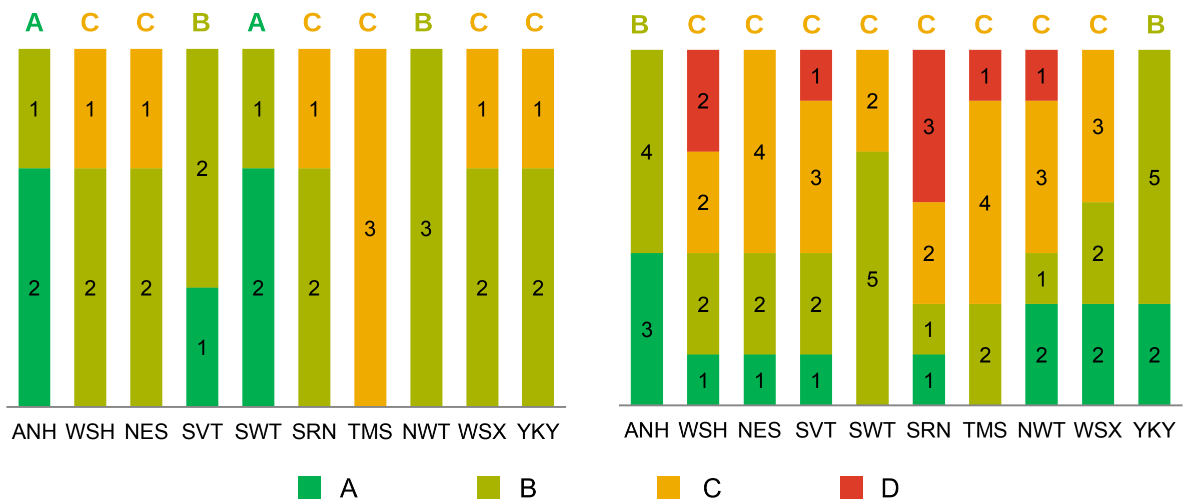
Results on PCs show promise but are also more mixed. Some companies have shown that it is possible to attain our high bar threshold. However, others have performed well in some test areas but less so in others. We have also observed that in some cases business plans show the transition that our PR14 approach is, with companies adopting a mix of inputs and outputs alongside outcomes within their proposed PCs.

Results for in-depth analytical tests and measurement/assurance tests

Company	VFM and costs	Track record/ commitment	Longer-term interests	Measurement and assurance
ANH	B	B	A	B
WSH	D	D	D	C
NES	B	C	B	C
SVT	D	C	C	C
SWT	C	B	C	B
SRN	A	A	C	D
TMS	D	C	D	C
UU	C	C	A	D
WSX	D	C	A	C
YKY	B	B	A	B
AFW	C	B	B	C
BRL	D	C	C	D
DVW	C	B	D	D
PRT	C	C	A	C
SBW	D	D	C	B
SEW	B	A	C	B
SSC	C	D	D	D
SES	C	A	C	C

Wastewater

Test 1 Customer engagement and WTP results **Test 2 Performance commitments results**



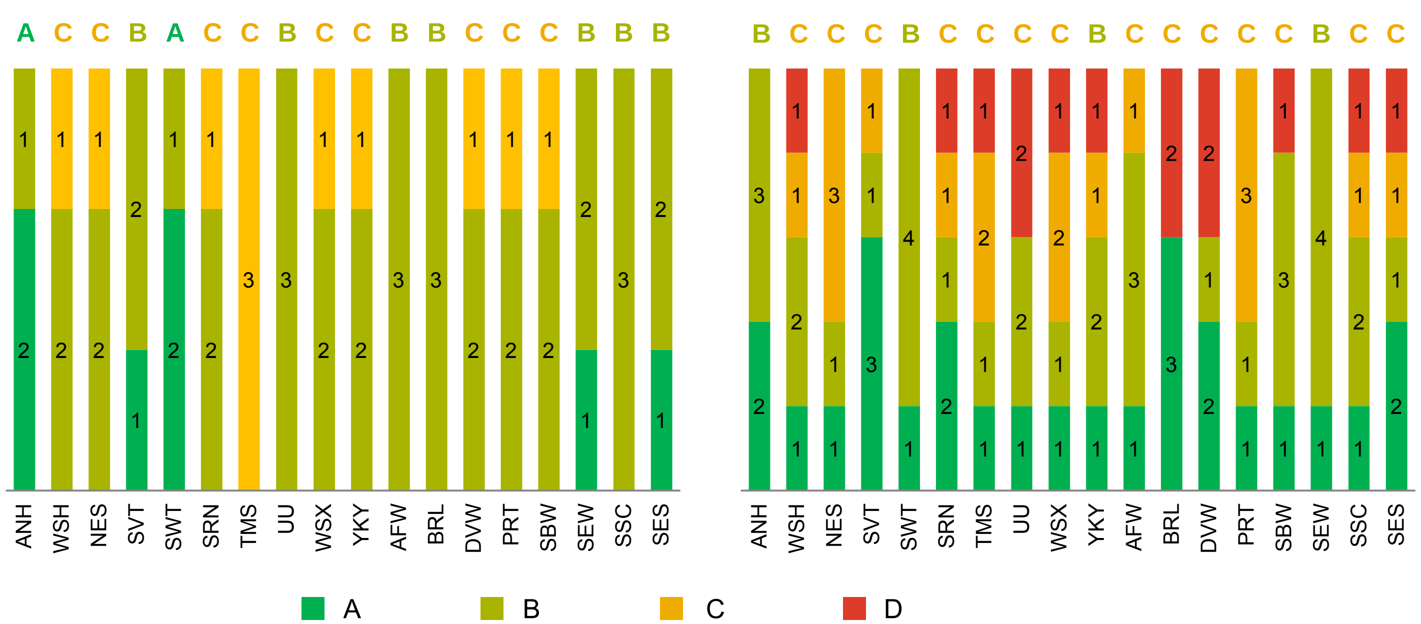
These graphs show the number of each score (A through D) each company has attained for the tests.

Results for in-depth analytical tests and measurement/assurance tests

Company	VFM and costs	Track record/ commitment	Longer-term interests	Measurement and assurance
ANH	B	B	A	B
WSH	D	D	C	C
NES	C	C	B	C
SVT	D	B	C	C
SWT	C	B	C	B
SRN	C	D	D	D
TMS	D	C	C	C
NWT	C	C	A	D
WSX	C	C	A	C
YKY	B	B	A	B

Retail

Test 1 Customer engagement and WTP results **Test 2 Performance commitments results**



These graphs show the number of each score (A through D) each company has attained for the tests.

Results for in-depth analytical tests and measurement/assurance tests

Company	VFM and costs	Track record/ commitment	Measurement and assurance
ANH	A	B	B
WSH	B	D	C
NES	C	C	C
SVT	A	A	C
SWT	B	A	B
SRN	A	B	D
TMS	D	C	C
UU	D	B	D
WSX	D	C	C
YKY	D	C	B
AFW	B	B	C
BRL	D	A	D
DVW	D	A	D
PRT	C	C	C
SBW	D	A	B
SEW	B	A	B
SSC	C	B	D
SES	D	A	C

Summary of risk-based review test

We assess companies' total wholesale water and wastewater costs (totex) by comparing the amount of expenditure that companies have requested in their plans with cost thresholds. These cost thresholds have been estimated using benchmarking models and have been adjusted for special factors (for example, environmental cost for designated areas) based on certain information contained in business plans; performance against the threshold will indicate whether companies' plans contain relatively low or high cost.

The cost thresholds set out in the tables are only applicable to the risk-based review process – plans that are currently below our threshold score A or B on the risk-based review test. The thresholds do not represent the baselines that we will use when setting the price control. We want to emphasise that a gap between the risk-based review thresholds and a company's business plan costs does not imply that a company is inefficient or that we will disallow any of the company's proposed costs. Gaps between the risk-based review thresholds and company cost projections highlight areas where there are opportunities for the companies to provide further information and evidence. For similar reasons, the presence of a C or D test score does not necessarily mean we will require companies to adjust this area of their business plan.

Why assess wholesale costs?

Over the period of the existing price control we are expecting wholesale total expenditure to be around £40 billion and for similar levels of spending in real terms over the period of the 2015 to 2020 price control.

How does the test work?

We looked at evidence in company business plans on whether to adjust the basic cost thresholds. In particular, when considering whether we should adjust the cost threshold for a particular programme of spending we considered the following criteria. (i) Is there compelling evidence of need for the programme? (ii) Is it justified by cost benefit analysis and strategic optioneering? (iii) Is there robust evidence on costs and are there wider issues to consider in relation to whether the interests of consumers will be properly protected? Where a company provided compelling evidence in relation to these matters we then considered changing the cost threshold – assuming that there was not already adequate funding in the cost threshold for the programme in question.

The test includes two criteria:

- quality of evidence (with the score taking account of any customer detriment associated with weakness in the quality of evidence); and
- position in relation to the cost threshold.

Both these matters are important (the former indicating quality of the business plan and the latter relative cost levels) so it is usually the lower of these individual scores that determines the overall score. Nonetheless, in exceptional circumstances where a test score has limited consumer detriment, regulatory judgement has been applied to allow a high score.

Below we highlight examples of exceptional aspects of business plans, as well as areas for improvement.

Examples of exceptional practice

Expenditure need – companies provided a clear case of need such as a statutory obligation.
Cost benefit analysis – companies provided evidence of a robust approach to strategic optioneering that takes into account appropriately specified costs and benefits.
Robustness of costs – companies provided evidence of benchmarking relating to the specific programme of work in question, where appropriate supported by third party assurance.

Examples where additional evidence or improvement is required

Expenditure need – no evidence or clear drivers to support need.
Cost benefit analysis – no evidence of optioneering.
Robustness of costs – no detailed breakdown of costs or explanation of benchmarking/validation of estimations.

Water company	Score			Company business plan £m	Risk-based review initial thresholds £m	Gap to B score £m (%)	Company business plan vs AMP5
	Overall	Evidence	Costs				
ANH	D	B	D	1,840	1,664	175 (11%)	+10%
WSH	C	B	C	1,257	1,229	28 (2%)	-6%
NES	B	B	C	1,363	1,359	3 (0%)	-2%
SVT	D	D	D	2,806	2,549	257 (10%)	+12%
SWT	B	B	A	697	826	-129 (-16%)	+9%
SRN	C	B	C	840	796	44 (6%)	-4%
TMS	B	B	A	3,160	3,766	-606 (-16%)	+7%
UU	C	B	C	2,379	2,309	69 (3%)	-4%
WSX	C	B	C	718	693	25 (4%)	+13%
YKY	B	B	A	1,428	1,593	-165 (-10%)	0%
AFW	B	B	B	1,049	1,099	-50 (-5%)	+3%
BRL	D	C	D	572	351	221 (63%)	+14%
DVW	D	B	D	102	89	13 (14%)	+24%
PRT	B	B	B	137	143	-6 (-4%)	+7%
SBW	C	B	C	136	130	6 (5%)	+2%
SEW	C	C	C	808	771	37 (5%)	+6%
SSC	C	B	C	409	398	11 (3%)	+7%
SES	D	B	D	241	219	23 (10%)	+10%
Industry				**19,940**	**19,984**	**-43**	**+4%**

Wastewater company	Score			Company business plan £m	Risk-based review initial thresholds £m	Gap to B score £m (%)	Company business plan vs AMP5
	Overall	Evidence	Costs				
ANH	C	B	C	2,525	2,469	56 (2%)	+18%
WSH	B	B	C	1,338	1,334	4 (0%)	+9%
NES	B	B	B	988	994	-7 (-1%)	+2%
SVT	B	C	B	2,657	2,730	-73 (-3%)	+7%
SWT	B	B	C	908	895	12 (1%)	+13%
SRN	D	C	D	2,029	1,654	375 (23%)	+5%
TMS (in TT)	D	D	D	4,307	3,583	724 (20%)	-20%
TMS (ex TT)	D	D	C				
UU	D	D	D	3,566	2,434	1,131 (46%)	-1%
WSX	C	C	C	1,131	1,032	99 (10%)	+30%
YKY	D	C	D	2,032	1,748	284 (16%)	+12%
Industry				**21,480**	**18,873**	**2,607 (14%)**	**+1%**

Key test results

Water wholesale costs

Out of the 18 water company business plans, six have been categorised as B, seven as C and five as D. The lowest cost company is 16% below its threshold and the highest cost company is currently 63% above its threshold.

Wastewater wholesale costs

Out of the ten wastewater company business plans, four have been categorised as B, two as C and four as D. The lowest cost company is 3% below its threshold and the highest cost company is currently 46% above its threshold.
Given the unique nature of the Thames Tideway project, we assessed Thames Water's wastewater cost both including and excluding its spending on this project.
The cost thresholds include allowances for the NEP Phase 5 for only five out of the ten wastewater companies and we anticipate that cost thresholds will increase as companies provide us with further evidence.

Summary of risk-based review test

The retail cost allocation test considers whether the company has appropriately allocated its costs between different parts of its business (that is, wholesale versus retail costs, and retail household costs versus retail non-household costs).

Why assess retail cost allocation?

Clear cost allocation ensures that companies can transparently show to their customers the cost s incurred in providing a service. With the introduction of non-household retail choice through the Water Bill this becomes even more important in order to avoid undue price discrimination and cross subsidies between customer groups.

How does the test work?

This test assesses how the company has allocated its costs between (i) its wholesale and retail business units, and (ii) its household and non-household retail business units as per our PR14 methodology. We test whether:

- companies' allocations are within 2% of our allocations based on either 2012-13 regulatory accounts (for retail/wholesale) or the number of customers, adjusted for directly attributable costs (for household/non-household);
- companies' allocations are in accordance with business planning guidance (within 2% materiality threshold); and
- companies' have provided relevant external assurance.

Company	Wholesale/retail allocation	Household/non-household allocation	Overall score
ANH	B	C	C
WSH	D	D	D
NES	A	B	B
SVT	B	D	D
SWT	B	A	B
SRN	B	A	A
TMS	B	B	B
UU	B	A	A
WSX	B	B	B
YKY	A	D	C
AFW	C	D	D
BRL	A	C	C
DVW	C	D	C
PRT	A	C	C
SBW	D	D	D
SEW	A	A	A
SSC	A	A	A
SES	B	D	D

Below we highlight examples of exceptional aspects of business plans, as well as areas for improvement.

Examples of exceptional practices

One company has introduced a high level of functional separation between household and non-household retail ensuring that 90% of its retail costs are directly attributable (for example, the company has separate teams for household and non-household debt management and customer services).

Directly allocating costs between household and non-household where possible (for example, one company has allocated customer-side leaks on a job-specific basis and demand-side water efficiency and doubtful debts on a customer-specific basis).

Using more cost-reflective cost drivers than those proposed in our guidance, one company has either directly attributed its costs between household and non-household or used what we consider to be a better cost driver than customer numbers to allocate all of its costs.

Allocating costs between price controls on a cost-reflective basis (for example, using time spent based on timesheets).

Examples where additional evidence or improvement is required

Not referencing costs (for example, local authority rates, disconnection costs, vulnerable customer schemes, regulation costs) meaning that we cannot confirm that these costs have been allocated correctly.

Allocating costs to the incorrect price control, for example, allocating scientific services or meter maintenance and installation to retail or allocating developer services to household retail.

Not splitting costs that should be split between retail and wholesale (for example, disconnections, developer services, local authority rates) or splitting costs that should be 100% attributable to retail (for example, network and non-network customer enquiries and complaints, demand-side water efficiency, customer-side leaks).

Allocating costs using a cost driver that is not in line with business planning guidance or is not a better, more cost-reflective cost driver (for example, using number of bills raised to allocate costs other than billing, using total debt outstanding to allocate doubtful debts or using number of metered properties to allocate meter reading).

Key test results

There has been strong progress towards consistent cost allocation across the sector, with many companies providing sufficient evidence to demonstrate they have appropriately allocated costs between price controls.

Nevertheless to reduce the risks of inconsistency in market definition/discrimination, we intend to issue further rules to companies about which cost drivers they must use in allocating their costs.

This means that all companies will need to resubmit their cost information regardless of whether they performed well in our risk-based review test or not. We have taken into account these considerations when looking at the cost allocation test in the overall context of the risk-based review.

Summary of risk-based review test

The test assesses to what extent companies have provided sufficient evidence to show that the average cost to serve (ACTS) should be adjusted for individual companies. The test also considers whether increases in household retail cost forecasts per customer ('new costs') are justified.

Why assess ACTS adjustments?

The ACTS test assesses the extent to which companies' retail costs are efficient against the industry average. Companies can make a case that they are not 'average' because of certain factors affecting their area.

The ACTS is calculated on a 'base year' (2013-14). Companies can make a case for modifying their cost to serve to account for forecast 'new costs', if they believe that 2013-14 costs are not representative of ongoing costs.

How does the test work?

The ACTS adjustments and new cost test is based on a two step approach. Firstly, a shallow dive assessment identifies whether an adjustment:

- has a material impact on costs;
- is covered by other policy (for example, pension deficit recovery costs have been previously specified and will be allowed; several proposed adjustments have also been assessed as 'new costs', for example social tariffs).

Material adjustments are then assessed against whether:

- they are beyond efficient management control;
- they impact the company in a materially different way to other companies;
- the size of the adjustment is justified.

Material new costs are assessed against whether:

- the need for the cost is justified;
- the cost represents the most cost beneficial solution;
- the quantum of the cost is justified;
- the cost protects customers.

Company	Bad debt	Input price pressure	Thames Tideway	Economies of scope	New costs	Overall
ANH	N/A	N/A	N/A	N/A	N/A	B
WSH	D	C	N/A	N/A	N/A	D
NES	D	C	N/A	N/A	D	D
SVT	N/A	D	N/A	N/A	N/A	D
SWT	C	N/A	N/A	N/A	N/A	C
SRN	C	C	N/A	N/A	N/A	C
TMS	N/A	N/A	D	N/A	C	D
UU	C	N/A	N/A	N/A	C	C
WSX	N/A	N/A	N/A	C	D	D
YKY	N/A	C	N/A	N/A	N/A	C
AFW	N/A	N/A	N/A	N/A	N/A	B
BRL	N/A	C	N/A	N/A	N/A	C
DVW	N/A	C	N/A	N/A	C	C
PRT	N/A	C	N/A	N/A	N/A	C
SBW	N/A	C	N/A	N/A	N/A	C
SEW	N/A	C	N/A	N/A	N/A	C
SSC	C	C	N/A	N/A	N/A	C
SES	N/A	C	N/A	N/A	N/A	C

Below we highlight examples of exceptional aspects of business plans, as well as areas for improvement.

Examples of exceptional practices

Not applicable – see key test results box.

Examples where additional evidence or improvement is required

Companies seeking ACTS adjustments for bad debt generally did not provide sufficient and convincing evidence that these costs are beyond management control.

Companies seeking input price pressure adjustments did not demonstrate that the management practices that they use to manage these cost pressures are efficient relative to the broader economy.

In relation to new costs, companies generally provided very limited evidence on the need for the investment or that the proposed investment is the most efficient option. In some instances companies had requested investments similar to those which they received funding for in the previous price control.

Key test results

Sixteen of the 18 companies proposed at least one ACTS adjustment. We need further information and dialogue on proposed adjustments across all business plans – in many cases companies provided insufficient supporting evidence – and in some cases these adjustments will need to be revised in later iterations of the business plans. For example, further evidence is needed to:

- demonstrate that the company has efficient management practice (including in relation to the broader economy) in managing these costs, including input cost pressures;
- demonstrate in a statistically robust way that the factor for which it is seeking an adjustment is beyond management control, particularly in relation to bad debts; and
- substantiate the need for new investments and that these investments represent the best option for customers and good value for money.

Summary of risk-based review test

This test considers how well the company demonstrated that its proposals are affordable over 2015-20 and that it has used appropriate means to secure the affordability of bills for customers. It also considers how clear it is that the company's proposals are affordable in the longer term and whether it has explored all possible options to ensure that this is the case.

Why assess affordability?

We have a statutory duty to protect the interests of consumers, and in doing so, to have regard to the interests of particular vulnerable groups, including individuals with low incomes (and future consumers). Therefore it is important to consider the overall impact of bills on customers from the business plans as part of the risk-based review.

How does the test work?

For PR14 we placed the onus on companies to demonstrate that their plans are affordable. We checked that companies have engaged with customers and stakeholders on their current and future affordability of their plans and adapted them in response to customer views. Companies also had to demonstrate that they have appropriately identified vulnerable customers and put in place appropriate means to address any remaining affordability concerns.

Key test results

There has been good customer engagement on affordability in 2015-20, but less engagement on future affordability.

Many companies tested the overall 'acceptability' of their plans rather than the 'affordability' directly. However, companies went on to explore which groups of customers found their plans unacceptable and for what reasons, including affordability concerns.

Some companies have not explored affordability in the longer term with their customers (that is, after 2020). However, in many cases, they have not sought to adjust profile revenue between 2015-20 and future periods.

Most companies proposed a range of measures to address affordability issues for targeted customers including:

- social tariffs;
- targeted metering roll out;
- WaterSure, WaterDirect;
- debt write-offs; and
- trust funds.

However, in some cases, companies have not been specific about how measures were going to be implemented such as number of customers impacted by measures.

Company	Bill change		2015-2020 affordability		Future affordability	Overall score
	Average household bill 2014-15 (£)	Change to average household bill by 2019-20 (£)	Acceptability reported in business plans	Criteria score	Criteria score	
ANH	412	-35	90%	A	B	A
WSH	419	-20	94%	B	B	B
NES	368	0	75%	B	B	B
SVT	316	-12	88%	B	B	B
SWT	512	-15	84%	B	B	B
SRN	413	-7	90%	A	C	B
TMS	349	+36	78%*	C	C	C
UU	395	-6	>75%*	B	B	B
WSX	459	-18	81%	A	B	A
YKY	351	0	75%	B	B	B
AFW	165	-6	87%	B	B	B
BRL	195	-2	92%	B	C	C
DVW	143	+13	71%	C	C	C
PRT	91	0	99%	B	B	B
SBW	149	-13	79%	B	B	B
SEW	195	0	86%	C	B	C
SSC	136	0	59%	C	B	C
SES	176	-8	84%	C	B	C

*TMS/UU estimates of acceptability are based on forecasts rather than survey results

While reviewing the company business plans we have noticed areas where companies will be required to provide further improvements to their plans. Below we highlight key areas of focus and how companies have been able to tackle this.

Examples of exceptional practices

An iterative approach to developing the business plan with multiple rounds of customer engagement enabling the company to develop its plan in line with customer expectations.
Explicit engagement with hard to reach customers.
Development of innovative and effective measures to assist customers with affordability concerns.
Customer engagement on the long term affordability of the business plan and reflecting their preferences in the future bill profile.

Examples where additional evidence or improvement is required

Failure to provide evidence of customers' views of the business plan.
Failure to capture representative sample of customers including sufficient vulnerable customers.
Failure to consider views of future customers.
Flexing financial levers to profile revenue between 2015-20 period and future periods without engaging with customers on their preferences.

Summary of risk-based review test

The board assurance test takes into account and balances a series of factors. The test itself covers to what extent:

- the company's Board has provided assurance that the business plan is of high quality;
- the company's Board's view of the plan is borne out by data and evidence provided elsewhere in the plan; and
- the company's Board has given adequate assurance that its outcomes are consistent with statements of obligations, relevant statutory requirements and licence obligations.

Why assess Board assurance?

To ensure that companies' Boards have taken ownership of, and demonstrated accountability for, the business plans they submitted.

How does the test work?

We used a two-stage approach. We initially assessed the process which the company's Board had provided assurance that its business plan was of high quality, including outcomes that are consistent with relevant obligations. We then looked at how the process which had been undertaken was borne out by data and evidence provided elsewhere in the business plan.

Below we highlight examples of exceptional aspects of business plans, as well as areas for improvement:

Examples of exceptional practices

Strong Board interaction with appropriately focused third-party assurance providers to derive high quality plans.

Innovative and clearly explained process that the Board has followed to assure itself that the business plan is of high quality.

Examples where additional evidence or improvement is required

Lack of sufficient evidence of Board assurance and oversight regarding the assumptions underpinning major investments.

Company	Assurance that business plan is of high quality	Quality of data/evidence supporting board view of plan	Assurance that outcomes are consistent with relevant obligations	Overall score
ANH	A	B	B	B
WSH	B	B	B	B
NES	B	C	B	B
SVT	B	C	B	B
SWT	B	B	B	B
SRN	A	B	B	B
TMS	B	C	B	B
UU	B	B	B	B
WSX	B	C	B	B
YKY	B	B	B	B
AFW	B	B	A	B
BRL	A	C	A	B
DVW	B	C	B	B
PRT	A	B	B	B
SBW	B	B	B	B
SEW	B	B	B	B
SSC	B	C	B	B
SES	B	B	B	B

Key test results

Overall, we commend the companies in responding to the challenge Ofwat put to them regarding Board governance and assurance, specifically the significant developments in this area for some companies over the past 12 months. We acknowledge this has taken a substantial effort from the Boards and Executive of these companies. Ofwat considers that this will deliver enduring benefits to customers as well the companies themselves.

The risk-based review process revealed areas in which we required additional evidence or confirmation that the assurance processes had delivered the required level of oversight.

Summary of risk-based review test

This test considers how companies have approached adjustments to their 2015-20 price control to reflect past performance.

Why assess legacy adjustments?

Companies have proposed substantial adjustments to their price limits in 2015-20 as a result of performance in the previous price control period (see box for more details on the five performance areas). We therefore need to check that all outputs were delivered for customers and if not that business plans include fair and appropriate adjustments to price controls.

How does the test work?

The test is based on two assessments. The first (1) examines to what extent has the company demonstrated clear evidence that it has made adjustments to 2015-20 price controls based upon its performance in 2010-15 in line with our guidance and tools (for example, whether any deviation from our guidelines is sufficiently justified). The second (2) examines how fairly the company proposals reflect its performance in 2010-15 by examining the scale of difference between the company and Ofwat views for each of the five tools. Adjustments can be made to the wholesale price controls, and therefore we have completed our tests for both wholesale water and wholesale wastewater.

PR09 incentive tools

SIM (service incentive mechanism) = incentive to reward good customer service
RCM (revenue correction mechanism) = tool to deal with differences between actual revenue collected and our assumptions for allowed revenue at PR09
OIA (opex incentive allowance) = balancing incentive for savings in operating expenditure designed to counter the effect of five-year price controls on investment decisions
Change protocol = tools used to deal with non-trivial capex changes in delivery from our assumptions at the 2009 final determinations
CIS (capital expenditure incentive scheme) = incentive used for capital expenditure, designed to reward both cost outperformance and accurate business plans

	ANH		WSH		NES		SVT		SWT		SRN		TMS		UU		WSX	
Wholesale water scores	1	2	1	2	1	2	1	2	1	2	1	2	1	2	1	2	1	2
Service incentive mechanism (SIM)	B	B	D	D	B	B	B	B	B	B	B	B	B	B	B	B	B	B
Revenue correction mechanism (RCM)	C	C	B	B	B	C	C	B	A	A	C	C	B	B	C	C	C	C
Opex incentive allowance (OIA)	C	D	B	B	A	B	B	B	B	B	B	C	B	B	B	B	B	C
Change protocol (logging up/down, shortfall)	C	C	C	C	D	D	C	C	A	A	D	D	A	A	C	C	D	D
Capital expenditure incentive scheme (CIS)	C	C	C	B	A	A	B	C	B	A	A	C	A	A	D	D	B	C
Overall score for each criterion	C	C	C	C	B	C	B	B	A	A	B	D	A	A	D	D	C	C
Overall score	C		C		C		B		A		D		A		D		C	

	YKY		AFW		BRL		DVW		PRT		SBW		SEW		SSC		SES	
Wholesale water scores	1	2	1	2	1	2	1	2	1	2	1	2	1	2	1	2	1	2
Service incentive mechanism (SIM)	D	D	D	D	B	B	B	B	B	B	B	B	B	B	B	B	B	B
Revenue correction mechanism (RCM)	C	C	C	C	C	C	D	C	C	B	B	B	C	C	D	C	B	B
Opex incentive allowance (OIA)	B	B	B	B	C	C	B	B	C	B	B	B	B	C	C	C	A	B
Change protocol (logging up/down, shortfall)	C	C	B	B	B	B	C	D	C	C	C	B	C	C	D	D	B	B
Capital expenditure incentive scheme (CIS)	B	B	C	C	D	D	D	D	B	C	C	B	B	B	D	D	B	A
Overall score for each criterion	C	C	C	B	C	C	C	D	C	C	B	B	B	C	D	C	B	A
Overall score	C		C		C		D		C		B		C		D		A	

	ANH		WSH		NES		SVT		SWT		SRN		TMS		UU		WSX		YKY	
Wholesale wastewater scores	1	2	1	2	1	2	1	2	1	2	1	2	1	2	1	2	1	2	1	2
Service incentive mechanism (SIM)	B	B	D	D	B	B	B	B	B	B	B	B	B	B	B	B	B	B	D	D
Revenue correction mechanism (RCM)	C	C	B	B	C	C	C	C	A	A	C	D	C	C	C	C	C	B	D	D
Opex incentive allowance (OIA)	C	D	B	B	B	B	B	C	B	B	B	C	B	B	B	B	B	B	B	B
Change protocol (logging up/down, shortfall)	C	C	C	C	C	D	C	C	A	A	D	D	C	C	C	D	D	D	C	C
Capital expenditure incentive scheme (CIS)	C	C	C	B	A	B	B	C	B	B	A	C	C	C	D	D	B	C	B	B
Overall score for each criterion	C	C	C	C	B	C	B	C	A	A	B	D	C	C	C	D	C	C	C	C
Overall score	C		C		C		C		A		D		C		D		C		C	

Below we highlight examples of exceptional aspects of business plans, as well as areas for improvement.

Examples of exceptional practices

Full account and comprehensive evidence of the extent to which the company had delivered their FD09 outputs .
Clear demonstration that adjustments follow our methodology and are supported by transparent and reasonable forecasts.
Exceptional evidence of a robust Board assurance process.

Examples where additional evidence or improvement is required to address

Lack of detail or evidence on individual adjustments , and the lack of detail around rewards/penalties (for example, SIM and CIS). Supporting commentary and board governance provides little or no evidence to explain the companies' proposals.
Misinterpretation of the incentive tool mechanisms (particularly for CIS and OIA incentive).
Seeking to return benefits to customers but making this conditional on Ofwat accepting other elements of their plan (for example, small company premium).

Key test results

Generally companies have provided some evidence to justify their proposed legacy adjustments and we have seen some examples of good practices in this area. However, in many cases additional work is required to address the following issues.

- Confirming rewards or penalties for each legacy tool, and allocation between water and wastewater controls.
- Providing a detailed gap / variance analysis of actuals and future forecasts.
- While a small number of companies have provided evidence to justify changes and to demonstrate the delivery of their investment programmes, this has not been the case across the sector.

Appendix 3: Decisions and process for pre-qualified companies

We have identified the business plans of South West Water and Affinity Water as being of a sufficiently quality to be categorised as pre-qualifying companies. This appendix provides an overview of these plans by identifying aspects of the plan that stand out as high quality.

The information presented in this appendix facilitates transparency of the risk-based review. As noted above, transparency is important to deliver the incentive properties of the risk-based review process. It also:

- provides clear signals to investors and other stakeholders about the quality of companies' business plans;
- promotes accountability and public trust; and
- provides valuable information to customers and other stakeholders.

A3.1 South West Water's business plan

South West Water's business plan met our expectations of a high-quality plan across the plan.

One of the reasons South West's plan stood out from most other companies was the strong focus on engagement and balancing the need to keep customers' bills affordable while also investing in the environment and service improvements.

For example, the company's engagement programme ran for two years across two phases – understanding its customers' priorities and then presenting customers with them with investment and bill options to choose from.

South West Water demonstrated in its business plan how successive rounds of engagement fed into further engagement and its plan. After finding that less than two-thirds of its customers found its initial proposals acceptable, the company reduced its proposed average bill at the end of the period by £31. It did this by scaling back investment in areas such as the duplication of strategic water mains, sewer separation and smart metering and challenging itself further on efficiency. The company also has a comprehensive range of schemes in place to support customers' who would still find its proposals difficult to afford, including a social tariff it put in place in 2013-14.

The focus on affordability and efficiency, through the use of new technology, partnership working and innovative approaches, is also evident in other areas of the company's plan.

For example, South West Water's plan includes proposals for a new water treatment works for North Plymouth that uses cutting-edge technology to deliver improved drinking water at lower long-term cost. This is because the treatment process has low energy and chemical requirements and generates low amounts of waste.

The company is also proposing to work in partnership with other parties to pursue low-cost sustainable solutions for improving water quality, managing flood risk and improving the resilience of its service. Its Upstream Thinking programme, for example, involves working with charitable organisations, land owners and the Environment Agency to continue its award winning work on improving catchments that are designated Drinking Water Protection Areas. Its Downstream Thinking programme involves working with parties such as developers and local flood authorities on a range of drainage management initiatives, including those focusing on sustainable drainage.

South West Water is also proposing to deliver its proposed improvements to its retail service at no additional cost to its customers and absorb cost increases through efficiency savings.

Finally, the company's plan also stood out because of a desire to build legitimacy with its customers. The company partly demonstrated this through its engagement with customers, but also through its approach to measuring and sharing performance over 2015-20.

South West Water's business plan contains a Board pledge to share the benefits of success fairly between customers and investors. In line with this it is proposing an independently monitored and transparent performance sharing framework called 'WaterShare'. This framework would involve the company publishing a scorecard on an annual basis that summarises its performance and would allow for the sharing of net gains with customers in a timely manner.

We also consider that the company's business plan met our expectations in relation to Board assurance, with its Board's view that the plan is high quality being supported by evidence and data from the rest of the plan.

Within our assessment we identified that South West Water has some actions to resolve.

- Performance commitments for its wholesale water and wastewater proposals (relating to only a small number of criteria).
- Proposed bad debt adjustment to the average cost to serve.

A3.2 Affinity Water's business plan

Affinity Water's business plan met our expectations of a high-quality plan across the plan.

Affinity Water's business plan identified the major challenges it faces over the forthcoming regulatory period. Affinity Water sought views from its customers, as well as the wider consumer interest to shape its business plan.

For example, the company identified that it would face a supply/demand deficit due to increasing demand and the need to leave more water in the environment. Affinity Water operates in an area of serious water stress and has agreed with the Environment Agency to reduce the amount of water it abstracts by 42 million litres a day by 2020 – nearly 5% of its supply. Affinity Water's customers told the company that they prefer demand management options over supply-side options. As a result, Affinity Water is proposing to reduce demand through metering and a water efficiency programme. However, the company is also proposing to use water more efficiently, including a proposed cut in leakage by 14% by 2020.

Affinity Water also identifies affordability as a key challenge going forward. The company engaged with its customers and provided convincing evidence that its plan is affordable. However, it acknowledges clearly that the impact of the Thames Tideway Tunnel is going to make the combined water and wastewater bill unacceptable. In response to this, Affinity Water has agreed with its CCG that it will devise a comprehensive communication programme to inform customers of potential price changes and take steps to mitigate the impact on vulnerable and low-income customers. The company is committing to introduce a social tariff in April 2014, which it expects will attract up to 30,000 more vulnerable households.

Affinity Water provided convincing evidence that its plan is efficient. It has delivered significant efficiencies during the past four years that are incorporated into its totex (total expenditure) projections, which include further significant efficiencies across your wholesale base totex. It is also proposing to deliver efficiencies in retail costs to offset any input price pressure.

Both Affinity Water's plan and company vision (to be the UK leading community-focused water company) is innovative. The company will report its performance at a community level as well as at a company level. This is intended to enable customers within their communities to judge how well Affinity Water is meeting the expectations it set itself and to better hold it to account. The company is committed to customer-focussed innovation and its 'Voice of the Customer' programme – which integrates feedback from 1,000 customers every week through a number of channels ranging from the traditional to the increasingly important digital channels and social media – creates a better understanding of customers' needs allowing it to tailor its services accordingly.

Affinity Water provided convincing evidence that its Board has provided strategic direction and leadership and it is clear that the CCG had good access to the company Board. Its Board states that the plan is high quality and this is supported by external assurance as well as from evidence and data elsewhere in the plan.

Finally, Affinity Water's business plan also highlights an opportunity: increasing choice of supplier for business customers. The company acknowledges that in a fully competitive market its success will be measured by how well it retains and serves existing and new customers. The company plans to develop a business SIM measure tailored to its business customers and to use focus groups of commercial users to create dialogue about how the company can better serve their needs. The company also plans to develop and publish a Business Customer Charter.

Within our assessment we identified that Affinity Water has some actions to resolve.

- Performance commitments for its wholesale water and retail household proposals (relating to only a small number of criteria).
- Allocation of costs between the different controls.
- Adjustments to reflect actual performance in the 2010-15 period.

A3.3 Process for South West Water and Affinity Water

In our risk and reward guidance, we set out our view on the cost of capital and other key financial parameters. We said that pre-qualifying companies would need to adopt this to achieve enhanced status. Table 8 summaries the issues and our view on these, further information can be found in our risk and reward guidance.

Table 8 Summary of key issues and further guidance

Issue	Company proposals	Ofwat guidance
Appointee weighted average cost of capital (WACC) (equivalent to the PR09 WACC)	Appointee WACC exceeds market evidence on required returns.	Notional company vanilla WACC expected to be no higher than 3.85%. Any adjustment, for small companies, to this parameter must be cost beneficial to customers.
Retail profit margins: household/non-household	There is wide variation in estimated retail margins, broadly in line with regulatory precedents.	Retail household and Wales non-household margin: 1.0%. Retail non-household margin (England): 2.5% (of which 1.5% reflects premium allowed for risk and is additional to appointee WACC).
Wholesale WACC	Exceeds market evidence.	3.7%, calculated by deducting retail margins (excluding premium for competitive risks in non-household) from the appointee WACC.
Outperformance	Wide variation of proposals from companies, including variation in level and balance of cost performance and outcome delivery incentives (ODIs). Data from companies indicate that total expected upside is less than 2.0% for most companies. Most proposed ODIs are either reputational or penalty only.	Overall return on regulatory equity (RoRE) range of +/- 3.5% to 4.5%, in line with regulatory precedents. Companies should reconsider overall scope for outperformance from cost, ODIs, service incentive mechanism (SIM) and financing. This is in order to provide an effective package of rewards and penalties that will provide meaningful incentives to encourage the best service. Companies should resubmit ODIs with meaningful rewards and penalties as part of this package.
Uncertainty mechanisms	There is wide variation in how companies have approached uncertainty mechanisms, which is not consistent with a single notional industry return.	Companies should provide greater transparency around pain/gain and how this is shared between customers and other stakeholders. Notified items will only be appropriate where the probability of an event or its impact cannot be influenced by a company.

Issue	Company proposals	Ofwat guidance
Process for adopting this guidance	n/a	Explains process for revising business plans.

Any revised business plans submitted by 10.00 am on 17 March 2014 should fully assess the impact of changes on the financing of the business plan and be accompanied by a Board assurance statement that confirms that it can be financed.

We will then assess whether companies:

- **accept our guidance** on appointee returns and our view on the cost of capital and retail net margins;
- adopt **all other aspects of our January guidance**, including the need for outcome delivery incentives and uncertainty mechanisms to align with the parameters set out in the guidance; and
- **continue to pass** all the tests used for pre-qualification, including our tests for affordability and Board assurance.

On **4 April 2014**, we will confirm whether the two companies submitted revised risk and reward proposals and whether we accept that these new proposals are in line with our guidance. We will make our draft determinations for enhanced companies on **30 April 2014**.

Our risk and reward guidance set out what information we expected pre-qualified companies to provide, if they are seeking enhanced status. Pre-qualified companies that do not revise and re-submit the relevant aspects of their business plans will be classified as standard. We do not expect companies to re-submit the entirety of their business plans; only commentary, supporting information and data tables that are different to the original submission.

Where revised information is provided, it must be sufficient for us to determine whether the revised plan meets the risk-based review tests set out in our methodology statement. Table 9 summarises the information we identified for submission. Further information can be found in our risk and reward guidance.

Table 9 Summary of information requirements for pre-qualification companies

Risk-based review tests	Summary
Consumer engagement and WTP information	There is no regulatory requirement in this area for pre-qualifying companies. Company Boards should consider the appropriate engagement with customers around the risk and reward package.
Performance commitments	Companies should **only revise** or re-submit information on performance commitments where this is **necessary** to support their revised ODIs. They will need to demonstrate link between an increase in ODIs and performance commitment.
ODIs	Companies **should** revise their ODIs, as required. They should submit sufficient and convincing evidence that their ODIs appropriately incentivise performance. And they should demonstrate that their revised business plans contain proposed risk/rewards within the parameters set out in this document, including our guidance on how under-/overperformance impacts on RoRE.
Wholesale cost assessment	Companies should **not revise** or re-submit information on totex and cost composition. They **should** revise information on uncertainty mechanisms. And they should generally assume that exceptional cost performance proposals will be limited to those that align with the guidance set out in this document.
Retail cost allocation	Companies should **not revise** or re-submit their cost allocation proposals.
ACTS adjustments	Companies should **not revise** or re-submit their cost adjustment proposals.
Default tariffs	We have removed the determination of default tariffs from the RBR and instead require further information on the basis of companies' existing business plan proposals by 1 March. Companies should **not revise** or resubmit information on default tariffs.
Risk analysis	Companies **should provide** sufficient and convincing evidence that their revised business plans contain proposed risk impacts within the parameters set out in this document. In relation to scenario analysis, companies are required to re-submit information in relation to Scenario I only (that is, the overall scenario). Further information on how we expect them to demonstrate that their business plan contains an appropriate balance of risk and reward is provided below.

Level and allocation of risk	Companies **should provide** sufficient and convincing evidence that their revised business plans contain an appropriate balance of risk and reward, including demonstrating an efficient level and allocation of risk. As above, they should revise aspects of their business plan that relate to table A8 and Scenario I from table A20. Further guidance is provided below.
Rewards and returns	Companies should confirm they **adopt** our guidance on an appropriate industry-wide wholesale WACC. They should revise their risk and reward proposals in line with this guidance. Any small companies that are seeking adjustments to this guidance must provide evidence that this is cost beneficial to customers.
Retail net margins	Companies should confirm they **adopt** our guidance on appropriate household and non-household net margins. They should revise their risk and reward proposals in line with this guidance.
Financeability	Companies **may** vary their use of new regulatory mechanisms such as the PAYG ratio and regulatory capital value (RCV) runoff rate, if required. They should provide sufficient and convincing information to demonstrate their business plans – including revisions – are financeable.
Affordability	Companies **should provide** sufficient and convincing information to demonstrate that their revised business plans remain affordable to customers.

Appendix 4: Benefits for enhanced companies

In our final methodology statement, we confirmed that there would be reputational, financial and procedural benefits for companies that produced high-quality business plans.

In this appendix, we outline the combination of financial, reputational and procedural incentives we are offering to enhanced companies. We invite the Boards of pre-qualified companies to consider these incentives alongside our risk and reward guidance. In particular, these companies will benefit from:

- an initial financial award and an enhanced cost performance menu;
- our 'do no harm' principle, which will ensure that enhanced companies will not be any worse off for being categorised as enhanced;
- reputational benefits; and
- an early draft determination.

The following table summarises the financial, reputational and procedural benefits for enhanced companies in each area, with further detail in the sections that follow.

Table 10 Summary of the financial and procedural benefits of enhanced categorisation

Benefit	Summary
Financial benefits	We are offering enhanced companies an incentive package of (i) initial award of £11 million to South West Water and £4 million to Affinity Water reflecting the scale of the two companies. South West Water and Affinity Water are invited to propose how this award is recovered over time in net present value neutral manner and (ii) an enhanced menu, with a cost sharing rate that is 5% higher for both under- and over-performance (a symmetric menu).
'Do no harm' principle	We are offering enhanced companies a range of commitments to ensure that they will not be any worse off for being categorised as enhanced and receiving an earlier draft determination. These relate to: • movements in capital markets; • early material changes in companies' statutory obligations; • any relevant new sector-wide uncertainty mechanisms; • The impact of Ofwat policies on form of control, default tariffs, charging, SIM, financial reporting and monitoring; and • the impact of new data (for example, industry data, RPI data) on our final determinations.
Reputational incentives	Public recognition and acknowledgement of a high-quality and customer-focused plan.
Early draft determinations	Enhanced companies will receive early draft determinations on 30 April. All companies will receive a final determination at the same time, in December 2014.

A4.1 Financial benefits

In reaching our conclusions on the financial incentives for enhanced category companies, we have considered a range of options for the individual components.

- **Structure of the incentive package** – the extent to which the package should consist of only an enhanced cost menu or an initial award (an upfront amount for the enhanced company).
- **Whether the enhanced costs menu should be symmetric** for both under- and outperformance or asymmetric.

- **Size of the incentive package**, balancing the need to provide sufficient incentive for companies to develop high quality business plans while not exposing customers to risks of enhanced companies earning excessive returns.
- **Recovery of the initial award** – whether the initial award should consist of an addition to RCV, recovered in the allowed revenue in the 2015-20 period or some combination of RCV and revenue in 2015-20 period

We now discuss each of these elements.

A4.1.1 Structure of financial incentives

In our methodology statement, we stated that we would provide an enhanced menu allowing a greater share of cost outperformance, and that enhanced companies would be better off overall than other companies.

We consider that a combination of enhanced outperformance incentives and an initial award strikes the right balance between rewarding enhanced companies and protecting customers.

The initial award recognises the benefit to customers of a high quality business plan by providing a direct tangible incentive for which is not linked to outperformance against cost or other benchmarks. However, we consider it appropriate to place limits on the size of this award, since the award implies that customers will face slightly higher bills even if the company does not deliver above their business plan.

A4.1.2 Symmetric or asymmetric incentive

A symmetric incentive would mean that a company outperforming against its allowed expenditure would retain a greater share of outperformance, while an underperforming company would bear a greater proportion of the cost overrun.

An asymmetric menu incentive would mean that a company retains a greater share of cost outperformance, without the risk of greater exposure to underperformance. Whilst this protection would be attractive to enhanced companies, an asymmetric menu incentive would be significantly more complex to implement.

We have decided to set symmetric outperformance incentives on the cost menu to provide long-term incentives for development of realistic high-quality business plans in the future, provide strong incentives for outperformance in the current period and to avoid the additional complexities associated with implementing asymmetric incentives. We consider that our proposal to provide an initial award significantly mitigates the risk of underperformance.

A4.1.3 Size of incentive package

In calibrating the value of the financial incentive, we recognise the need to provide sufficient incentive for companies to develop high quality business plans while not exposing customers to the risk of enhanced companies earning excessive returns.

In terms of setting enhanced cost outperformance incentives, we also need to ensure that the menu is practical and consistent with the basis for standard cost menus. We have not yet published the standard menus, but provided companies with a working assumption of 50% cost sharing when the ratio of the company's baseline and Ofwat's baseline is equal to 1. We propose to set the enhanced cost outperformance incentive as an incremental percentage above the standard menu. In deciding the size of this increment, we need to consider the practicality of menu design, providing clear signals to companies and ensuring that returns are proportionate with benefits to customers from enhanced delivery incentives.

We have decided to set the cost sharing rate in the enhanced cost menu at 5% above the standard menu. A significantly larger amount would result in relatively little benefit to the customer from any outperformance by the company, and a smaller amount would provide little incentive for outperformance.

The value of this incentive will depend on the cost performance over the 2015-20 period. An enhanced company will only obtain a reward from this element of the incentive package if they outperform their allowed expenditure. Both Affinity Water and South West Water have proposed cost baselines below the allowed cost threshold for each company, so we have estimated the potential benefits to the companies under the assumption that their cost performance is consistent with their plans.

For South West Water, we estimate that the benefit of an additional 5% cost outperformance incentive could be about £6.0 million and for Affinity Water about £3.3 million over the 2015-20 period.

The initial award should be consistent with the long-term interest of customers by providing sufficient reward for the development of high quality future business plans. The cost outperformance menus relate to the level of totex, and therefore this element of the reward is linked to the size of the company's totex programme. However, the initial reward need not be linked to the size of the totex programme and could be based instead on the RCV or allowed revenue. We consider that it is appropriate to consider a range of scale measures, so as to ensure that the size of the reward reflects both the need to protect customers and to provide appropriate incentives for the companies. We are offering an initial award of £11 million for South West Water and £4 million for Affinity Water. This provides a significant reward for a high-quality business plan but is also consistent with a substantial proportion of the total reward package being earned from cost outperformance.

A4.1.4 Recovery of the initial award

The initial reward could be recovered in the 2015-20 period or added to the RCV at the beginning of the period and recovered over time. Recovery in the period would have the largest immediate impact on customer bills, while recovery through the RCV would imply a smaller bill increase in both 2015-20 and subsequent periods. This is consistent with the fact that a high-quality business plan will impact on customers both in 2015-20 and beyond.

We propose to invite the pre-qualified companies to consider how they prefer to profile the recovery of the initial award on a net present value (NPV) neutral basis. This will allow the company to consider the interests of its own current and future customers and the wider context of its business plan.

A4.2 'Do no harm' principle

We have established a principle that enhanced companies should be better off overall than other companies as long as they deliver their business plans.

Our risk and reward guidance set out how we would apply the 'do no harm' principle from a risk and reward perspective. We now confirm how the principle applies to other areas where enhanced companies may face some uncertainty as a result of the timetable for the price control.

One of the rewards for enhanced companies is that they will receive early draft determinations. However, this means that enhanced companies are subject to processes which are different to those of other companies and which follow different timescales. The divergence in the paths taken by enhanced and other companies should not introduce risks for enhanced companies such that the prize for enhancement is diluted.

There are various uncertainties which enhanced companies could perceive as a risk, including:

- later Ofwat PR14 policy decisions, including the outcome of parallel policy consultations;
- availability of new regulatory data; and
- changes in external circumstances affecting all companies.

We consider the 'do no harm' principle should apply in relation to their **absolute position at a point in time** and their **relative position** in relation to other, non-enhanced companies.

Table 11 below details our approach, taking into account the risk to enhanced companies and the potential implications for customers. The nature of the commitment we are making depends upon the type of uncertainty.

Table 11 Approach to ongoing areas of uncertainty

Type of commitment	When appropriate	Applies to
Absolute	Applies where there is a change in external circumstances that requires an equivalent adjustment to all companies affected.	Movements in capital markets – affects **WACC** and **retail net margins**. Early material **changes in companies' statutory obligations** – applies to Environment Agency NEP5, supply pipes, and retail exit. Any relevant **new industry-wide uncertainty mechanisms**.
Relative	Applies where all companies will be subject to common regulatory frameworks in AMP6, irrespective of their business plan proposals and our RBR categorisation decisions.	Ofwat policies on form of control, default tariffs, charging, SIM, financial reporting and monitoring. New data (for example, industry data, RPI data).
No commitment	Applies to aspects of business plans that are different from other companies and which were material in our RBR testing and hence contributed towards the enhanced categorisation.	Retail or wholesale costs.

While consistency is important in some areas, there will be other areas where enhanced companies have arrangements that are intentionally distinct from the rest of the industry. As noted in the table above, we do not propose to adjust our determinations for enhanced companies to reflect other circumstances which impact on retail or wholesale costs.

A4.3 Reputational incentives

The designation of business plan as enhanced will enable investors and other stakeholders to identify those companies that have high-quality plans.

A4.4 Early final determinations

In our final methodology statement, we said we would consider bringing the publication of enhanced company final determinations forward to increase procedural incentives through early regulatory certainty. We stated that we would need to consider carefully whether this could be accommodated within the overall price review process and timetable, and would be in the best interests of all parties.

We have weighed the additional benefits of early final determinations against the possible risks. We have concluded that it would not be appropriate to publish enhanced final determinations because:

- we want to ensure we have considered all responses to the later draft determinations to ensure we can reflect these for enhanced companies; and
- consistent RPI data for application to price limits will not be available until September 2014.

We propose to align the publication of final determinations for enhanced companies with the publication of final determinations for all companies on 12 December 2014.

A4.5 Review of incentives for enhanced category companies for the 2019 price review (PR19)

We propose to review the design and calibration of incentives for enhanced plans in the risk based review process as part of work towards PR19. The incentive package is an important tool for securing the long term benefits for customers from the development of high-quality business plans and from the delivery of these plans. We recognise that the incentive package is new and we will seek to understand the impact of the incentives and how they are aligned with the long-term interest of current and future customers.

Appendix 5: Service incentive mechanism (SIM) for 2010-15 and 2015-20

This appendix sets out our proposals for the operation of the SIM to assist pre-qualifying companies in their decision making. We provide further clarity surrounding the SIM for 2010-15 and the future direction of travel for the SIM in 2015-20. We are providing this information now to give as much information as possible to pre-qualified companies, or those who may seek an earlier draft determination around the SIM.

This will make it easier for those companies to assess the likely impact of the SIM going forward, including both the rewards or penalties they will receive for 2010-15 as well as the potential risks and rewards in 2015-20. This will, for example enable pre-qualified companies to make more informed decisions.

A5.1 Introduction

We introduced the SIM as part of water and waste water companies' price controls for 2010-15. It is a tool to encourage companies to improve customer service by reducing customer complaints and get things right first time.

We assess each company's customer service performance each year, using the following two sets of measures.

- A quantitative component comprising six customer handling metrics:
  - number of calls abandoned or engaged,;
  - unwanted phone contacts,;
  - written complaints; and
  - escalated complaints within the company and to the Consumer Council for Water (CCWater).
- A qualitative component based on the results of customer satisfaction surveys with a recent resolved contact (by any media for any reason).

Each component is scored out of 50 (for a total ‘SIM score’ out of 100) and, as part of setting price controls, companies are rewarded or penalised according to whether they are above or below the average score for the sector. The maximum reward for highly performing companies is capped at 0.5% of revenue of the appointed company’s integrated business; the maximum penalty is capped at 1% of revenue.

A5.2 Guidance on SIM scores and incentives for AMP5

In IN13/11, ‘Publication of service incentive mechanism (SIM) statistics for 2011-13’, we explained that we would adjust each company’s price controls for 2015-20 based on its SIM performance. We also said that we would use a company’s SIM score during the three years 2011-12 to 2013-14 to decide whether they should receive a reward or penalty. The reward or penalty they receive will be in the range of +0.5% to -1.0% of a company’s regulated turnover and will be determined by the industry average SIM score and a company’s SIM score relative to that average (measured by the number of standard deviations from the average).

In August 2014, we will publish three full years of SIM data (for 2011-14) and the rewards and penalties that each company will receive. We cannot do this until we have received the data from companies including for the final year 2013/14.

For enhanced companies, or those seeking earlier draft determinations, we are providing additional information on the direction of travel for the SIM to enable them to make more informed decisions. But clearly the full impact of the AMP 5 SIM will not be available until August. This information will form part of our draft determinations of companies that are undertaken in August. Enhanced companies’, or those seeking earlier draft determinations than August will still be able to make representations to us on the SIM before we make our final determinations.

In IN 13/11, we also confirmed the average SIM scores for each company based on the first two years of SIM data (2011-12 and 2012-13) and we indicated that companies would be able to use this information alongside our methodology to draw their own conclusions about their relative performance and likely rewards or penalties. We have summarised this information below in table 12 while figure 1 sets out the illustrative rewards and penalties associated with the SIM for 2010-15.

Table 12 Two-year average SIM scores compared to industry average

Company	Two-year average SIM score	Comparison to industry average
South Staffs/Cambridge Water	86	More than one standard deviation above the industry average
Sembcorp Bournemouth Water	86	
Bristol Water	85	
Wessex Water	85	
Anglian Water	82	Between the industry average and one standard deviation above
Dŵr Cymru	81	
Affinity Water	79	
Northumbrian Water	79	
Sutton & East Surrey Water	79	
Yorkshire Water	77	
	76	**Industry average (standard deviation = 8)**
Severn Trent Water	74	Between the industry average and one standard deviation below
Dee Valley Water	73	
United Utilities Water	73	
South West Water	69	
Portsmouth Water	66	More than one standard deviation below the industry average
South East Water	64	
Southern Water	64	
Thames Water	63	

Figure 1 Illustrative relative performance rewards and penalties based on two-year SIM scores

A5.3 Guidance on SIM direction of travel for 2015-20

In our final methodology statement, we confirmed that we would use the SIM as a standard minimum national incentive for customer service for 2015-20. We also confirmed that its likely scale and scope would be similar to the current SIM, but that it would apply only to the household retail price control in England and both retail controls in Wales (because of the Welsh Government's policy decision not to introduce choice for non-household customers). We committed to consulting in the autumn on changes to the SIM over the period 2015-20.

In 'Service incentive mechanism (SIM) for 2015 onwards – a consultation', which we published in October 2013, we consulted on the:

- design of the SIM for 2015-20; and
- application of the incentives to the price controls set for 2020 onwards (based on performance during 2015-20).

To enable pre-qualified companies to make informed decisions about the SIM incentive contribution to their risk and rewards and to provide maximum certainty for 2015-20, we think it is helpful to clarify certain aspects of the form of the SIM reward/penalty and how the incentive scoring will work (with further specific details of the SIM to be published later).

Below, we set out below the direction of travel in five key areas of the SIM for 2015 onwards to give companies additional clarity on the potential risk and reward they could face. This would also apply to the non-household SIM for companies in Wales.

A5.3.1 Form of incentive

We consulted on whether SIM for 2015 onwards should be used to incentivise:

- further improvements in the service that the best performing companies in the sector offer (the 'frontier');
- improvements by the less well performing companies in the sector, while maintaining frontier performance at current levels; or
- some combination of both.

In our consultation, we said that the case for using the SIM in a form similar to the current incentive to continue to drive improvements in less well performing companies appears to be strong. So, we said that it should continue to incentivise service improvements in companies operating below the frontier. We also said that we should only incentivise further frontier improvements if there is compelling evidence that the benefits of doing so exceed the additional costs.

We received mixed views on this issue in response to our consultation, although most companies argued that SIM should be used to incentivise all companies, not just improvements among those that are performing less well. But respondents provided little evidence to show that the benefits of doing so exceed the additional costs. So, we will use the SIM for 2015 onwards in a form similar to the current incentive to continue to drive improvements in less well performing companies.

A5.3.2 Symmetry of the incentive

We also consulted on whether the SIM going forward should involve a symmetric or asymmetric incentive. The current SIM incentive is asymmetric – that is, there is greater downside risk (maximum penalty of 1% of revenue) than upside potential (maximum reward of 0.5% of revenue).

Most respondents favoured retaining the current asymmetric structure because of the successes of the current SIM. But some expressed concerns over customer willingness to pay for rewards. We have decided to retain the current asymmetric structure of the SIM incentive.

A5.3.3 Magnitude of financial incentive

We consulted on whether the current scale of the SIM financial incentive (+0.5% to -1% of revenue) should be changed for 2015 onwards. We outlined our preference to broadly maintain the current magnitude of financial exposure under the SIM for 2015-20 as this will continue to drive improvements in service delivery.

Most respondents favoured retaining the current level of incentive as this has proven to be effective in improving the level of customer service across the sector. So, we will retain the financial magnitude of the current SIM (that is, the range of -1.0% to +0.5% on total integrated revenues), but will express this in terms of household retail revenues (+6% reward to -12% penalty).

A5.3.4 Use of absolute or relative performance

We consulted on the basis for determining rewards and penalties under the SIM. Specifically, we consulted on whether:

- companies should continue to be penalised or rewarded according to their ranking against other companies in the sector; or
- we should move to a system of rewards and penalties against an absolute performance level.

Most companies favoured retaining the current relative system. They thought that an absolute performance level risked not keeping pace with customer expectations of service and that the competitive nature of the SIM would be lost. As a result, we will retain the current relative performance approach of penalising/rewarding companies according to their ranking against others in the sector.

A5.3.5 Balance of qualitative and quantitative measures

Finally, we consulted on the balance between the quantitative and qualitative components of the SIM score, which are currently evenly weighted (50/50). Specifically, we consulted on:

- retaining the current 50/50 weighting;
- shifting the balance more towards qualitative measures (for example, 75% qualitative/25% quantitative);
- removing the quantitative measures entirely;
- shifting the balance more towards quantitative measures (for example, 25% qualitative/75% quantitative); or
- removing the qualitative measures entirely.

We said that our initial preference was to retain both types of measure, with some re-balancing over time to rely more heavily on qualitative measures to place greater weight on customers' views on satisfaction as may be appropriate.

We received mixed views on this from respondents. Some favoured retaining the current 50/50 weighting, while others favoured reducing the weight given to the quantitative measures. And some favouring removing the quantitative measures altogether. So, given the preference we set out in the consultation and responses we received, we will shift the balance of measures for 2015 onwards more towards qualitative measures (75% qualitative/ 25% quantitative).

A5.4 Next steps

In August, we will publish the full three years of SIM data (for 2011-14), and the rewards and penalties that each company will receive.

Also, on 4 April, we will publish the responses we received to the SIM consultation and our decision on the more detailed elements of the SIM and how they will operate for 2015 onwards.

Appendix 6: Process for all other companies

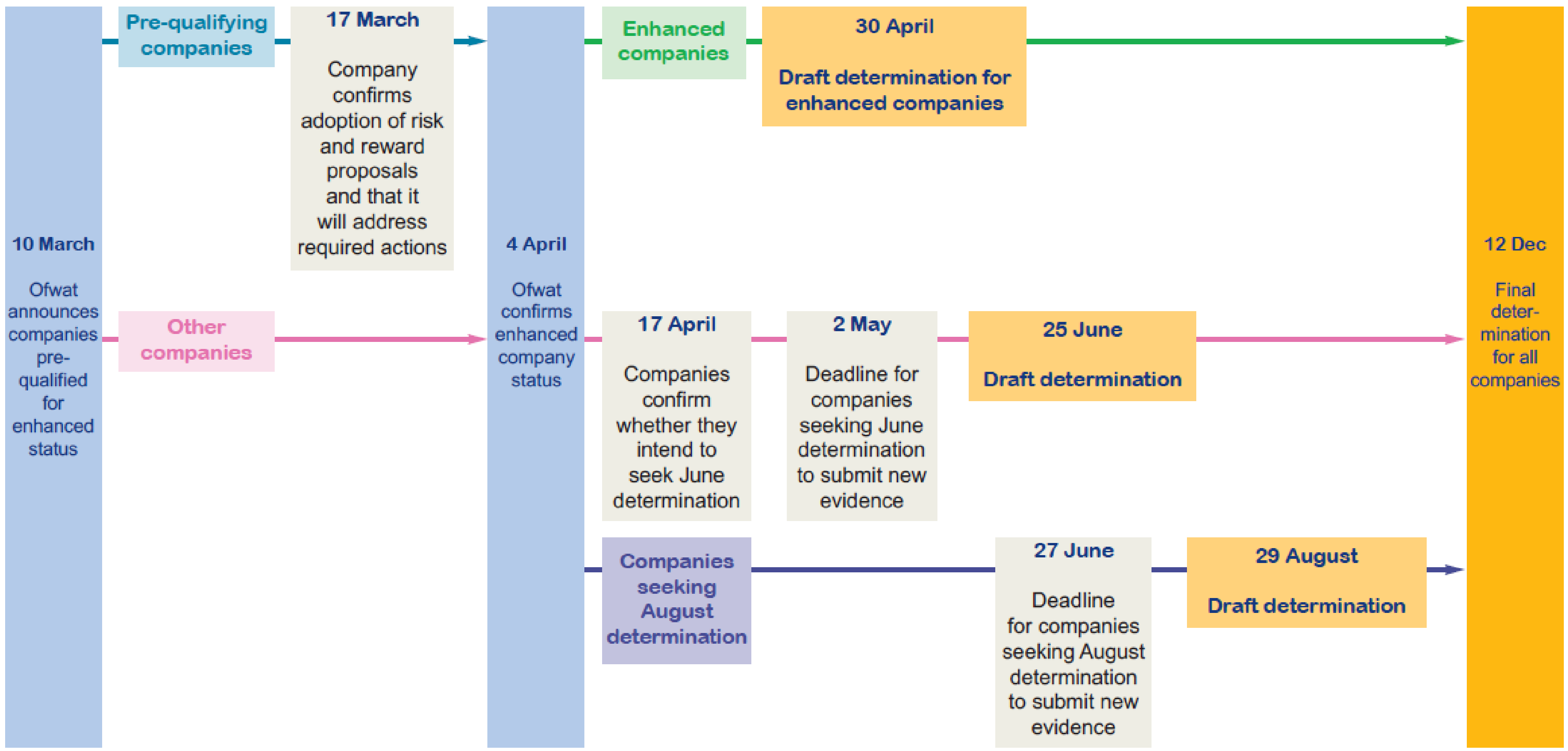
In this appendix, we summarise the steps that other companies will now follow, and set out some key actions these companies should consider.

To summarise:

- all non-enhanced companies have the opportunity to ask for an early draft determination;
- for us to accept a request for a June determination, we will need to satisfied that the revised business plan is of a sufficiently high quality and can form the basis of a draft determination without further regulatory intervention, consistent with our duties and the approach set out in our final methodology statement. If we do not consider that this high bar has been met the company will proceed to an August draft determination;
- for a June draft determination, the company will need to notify us by 17 April if they wish to submit new evidence by **2 May 2014**;
- where a company requesting an early draft determination meets the high standard we expect, we would issue the draft determinations on **25 June 2014**;
- companies that request, and are accepted for, a June draft determination will see some reputational and procedural benefit to bringing forward the draft determination. They will not receive the financial benefits available for enhanced companies;
- companies that are not enhanced and did not request a June draft determination must re-submit their business plans by **27 June 2014**. These companies will receive their draft determination on **29 August 2014**; and
- all companies – including enhanced companies – will receive final determinations at the same time in **December 2014**.

Figure 2 summarises the process for each group of companies.

Figure 2 Key milestones in the PR14 process



In reviewing their plans, and deciding what additional material to submit, it is for companies to determine the nature and content of their business plans.

They should do this in collaboration with their customers and other key stakeholders such as the environmental and quality regulators. To assist companies to meet this timetable, we will be providing further information where appropriate.

There are also a number of more specific actions that companies should consider when they are reviewing the relevant parts of their plans and determining what new evidence to submit to us.

- We would expect **CCGs to engage** on revisions to the plans. We would expect the focus to only been on areas we identified as requiring further work. Going forward, we would also expect CCGs to be involved in discussions around key company decisions in the process which will affect customers, such as the impact on bills.
- There should be a short, **supplementary CCG report** that addresses the key changes in any resubmission.
- Companies should provide a **Board assurance statement** that confirms that the business plan can be financed.
- We expect all companies to **take into account the risk and reward guidance** for their plans.

On 4 April 2014, we will be publishing more information on:

- wholesale cost assessment and models;
- outcome delivery incentives;
- cost drivers for the allocation of costs;
- the application of legacy (AMP 5) adjustments; and
- approach to default tariffs.

This additional information supplements information we have already shared through our:

- final methodology statement;
- risk and reward guidance;
- financial model, associated feeder models and risk assessment tools, which we published on 24 February; and
- the information presented in this document on SIM.

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We are responsible for making sure that the water sector in England and Wales provides customers with a good quality and efficient service at a fair price.

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7699
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gsi.gov.uk

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