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Trust in water

# **Delivering Water 2020: consultation on PR19 methodology**

## **Appendix 12: Securing cost efficiency**

**Appendix to chapter 9:  
Securing cost efficiency**

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## 1 Summary

This appendix provides further detail on our proposals for cost assessment set out in the cost efficiency chapter of our PR19 methodology consultation document. Where applicable we set out the issues we are seeking to address, the options we have considered and the reasons for our proposed approach.

This appendix covers further detail on:

- our proposal for the process of making adjustments to our cost baselines;
- setting efficient expenditure for water resources, bioresources and retail;
- our proposal for funding unconfirmed requirements from environmental regulators (enhancement expenditure); and
- our approach to addressing pension deficit costs and business rates.

## 2 Adjustments to our cost baselines

As we explained in the cost efficiency chapter, as cost models are necessarily imperfect and cannot take into account all relevant factors that affect costs, there may be instances where an adjustment is required to correct these imperfections. These adjustments may be upwards, to increase our modelled cost baseline, or downwards, to reduce our modelled cost baseline.

Below we set out the evidence that we expect from companies in support of cost adjustment claims. We then provide an example and explain in more detail our proposed mechanism for downward adjustments to ensure that the adjustment process adequately protects customers.

### 2.1 Evidence to support cost adjustment claims

Below we set out the types of evidence that we expect companies to submit in support of their cost adjustment claims. This builds on the evidence we used in PR14 to carry out the tests for assessing special cost claims.

- **Need for cost adjustment:** is there persuasive evidence that the cost claim is not included in our modelled baseline? Is it clear the allowances in the round would be insufficient to accommodate special factors without a claim?
- **Robustness and efficiency of costs:** is there persuasive evidence that the cost estimates are robust and efficient?
- **Management control:** is the cost driven by factors beyond management control? Is there persuasive evidence that the company has taken all reasonable steps to control the cost?
- **Need for investment:** is there persuasive evidence that the investment is required? Where appropriate, is there evidence of customer and CCG support for the project?
- **Best option for customers:** is there persuasive evidence that the proposed option represents the best value for customers? Is there persuasive cost benefit analysis (CBA) to support the option? Is there a consideration of risk and assessment of flexible solutions with lower risk? Is there a consideration of the impact on natural capital and ecosystem services where appropriate?
- **Customer protection:** are customers protected if the investment is cancelled, delayed or reduced in scope? Are customer benefits related to the claim linked to outcomes and a suitable incentive in the business plan?

We do not prescribe that all the evidence above is required for all types of claims. Different types of claims may require different evidence to support them. It will be for

companies to provide the appropriate evidence to support their claim. For example, a company may consider that to support a cost claim due to regional operating circumstances, such as exceptional congestion in the region or a local tax, a CBA is not required.

We will set a high evidentiary bar to accept a cost adjustment claim. Companies should follow a robust decision making process, with proper options assessment, and present robust evidence of cost efficiency. Without these we will not be persuaded to make an adjustment.

We expect companies to improve the quality of their CBA relative to what was submitted in PR14. The CBA should follow best practice with proper options assessment and a clear explanation of the assumptions used. The relevant options to consider will depend on the specific investment. However, we expect that investment to address supply-demand imbalances will consider the option of water trading. If such an option is not costed in the CBA, the company should explain why it is not. Supply-demand claims should be fully consistent with a company's Water Resources Management Plan. Likewise, for large investments that qualify for direct procurement, a company should evaluate such an option in its CBA or justify why it has not.

Where appropriate, we expect companies to extend the CBA to evaluate the 'real options' value of less risky solutions. This is particularly relevant for projects with a large unrecoverable (ie sunk) initial investment and where the need for the investment is uncertain (eg dependent on a possible future scenario). In such cases, we would expect companies to consider the value for customers of risk reduction associated with options that maintain flexibility to change course, defer, abandon or expand the programme of work.

For resilience claims we would expect companies to follow the principles set out in the Resilience chapter of this consultation. In particular, companies should provide evidence that they have considered different intervention options and that a claim provides resilience under realistic stress scenarios.

## **2.2 Materiality threshold**

We will apply a materiality threshold to cost adjustment claims. We will only consider claims that are above the materiality threshold. The materiality threshold ensures that we balance a proportionate regulatory approach with companies' exposure to claim costs.

At PR14 we used a materiality threshold of 0.5% for each of the wholesale water and wastewater price controls, and 2.25% for residential retail. The threshold for residential retail was calculated to be equivalent to the threshold on wholesale services given that retail is around 10% of the value chain.

For PR19 we propose to use the same materiality thresholds as at PR14. Under this proposal, the materiality of a claim in the water resources or the water network plus controls will be assessed against the total expenditure in the combined controls. The same applies to claims in bioresources and wastewater network plus.

A claim's materiality will be calculated for the value of the claim after any deduction for an "implicit allowance" (that is, an allowance for the claim which we consider is already included in the modelled cost baselines).

We welcome stakeholder views on this issue. We would also welcome views on whether a single materiality threshold at an appointee level would be more appropriate.

### **3 Setting efficient expenditure for water resources**

In our [May 2016 decision document](#) we set out our decision to have a separate binding control for water resources at PR19. We said that the water resources control will be a total revenue control, based on the building blocks approach, which will include an allowance for PAYG expenditure, return on capital, tax and previous investments represented by the RCV.

Water resources costs include all costs associated with the abstraction of raw water until it is delivered into the raw water distribution network.

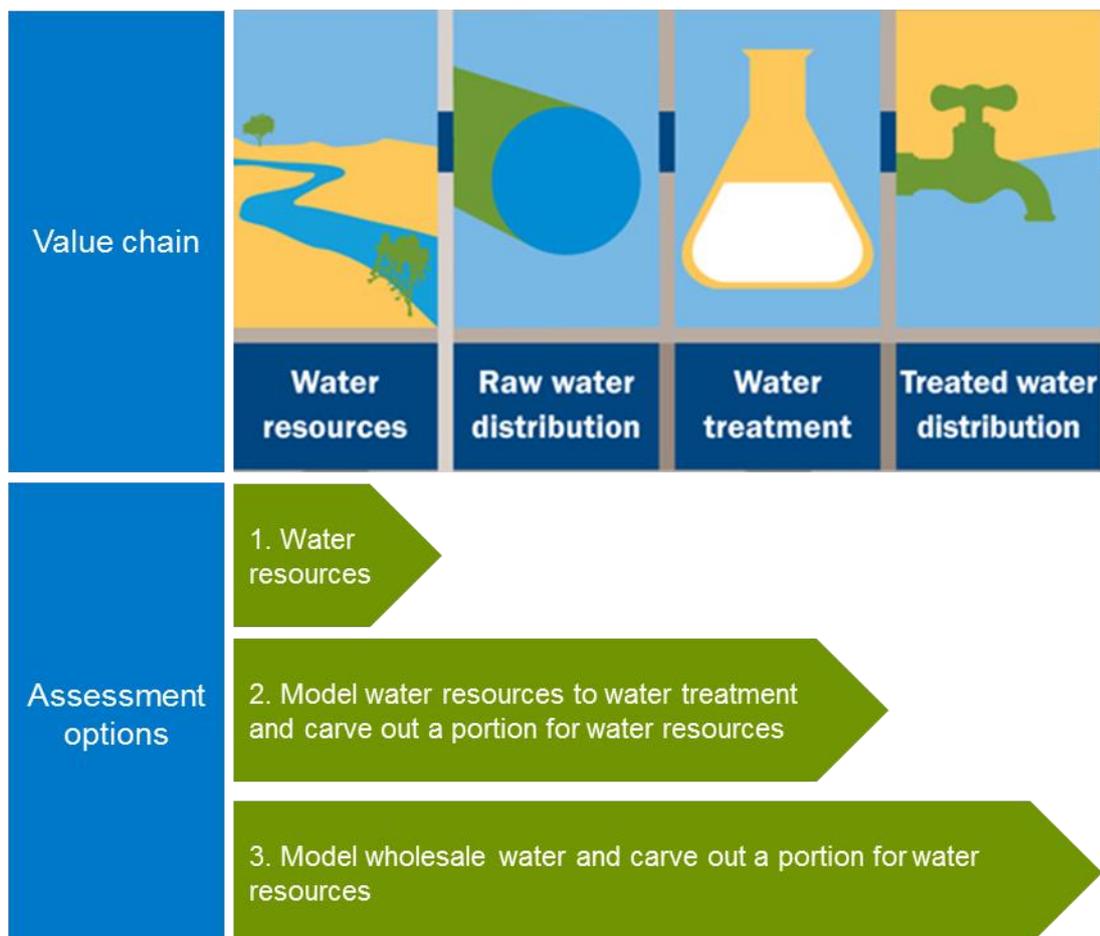
For the water resources control, we will set an efficient total expenditure allowance for each company to deliver water resources services from 2020 to 2025.

To set efficient totex baselines, we propose to use benchmarking analysis, with a range of aggregated and granular models. We discuss the benefits of benchmarking analysis in the cost efficiency chapter. Specifically, for water resources we will look to develop robust benchmarking models at different levels of cost aggregation as shown in figure 1.

### Figure 1 Options for assessing water resources' costs

Figure 1 shows three levels of cost aggregation. From a granular level that includes only water resources costs, a middle level that includes water resources, raw water distribution and water treatment costs, to an aggregate level where we benchmark wholesale water costs.

We think it is important to retain this range of options to estimate efficient water resources costs. Benchmarking at an aggregated expenditure level will ensure synergies and trade-offs between water resources and network plus are captured. Also, as separate reporting for water resources was introduced relatively recently and we have fewer reporting years with robust reporting at this level, using aggregate models is appropriate as we can use a longer time period of data and avoid inaccuracies arising from inconsistent allocation of data across the business units.



The middle level combines water resources, raw water distribution and treatment. These activities are closely linked as the water resources and treatment are often co-located on the same operational site (eg boreholes). The middle level also avoids

data allocation issues between the activities for costs such as power, maintenance and land purchase.

Benchmarking analysis under options 2 and 3 in figure 1 will provide us with an estimate of efficient costs at a more aggregated level than water resources. To set efficient cost baselines for water resources, we will have to further split the result between water resources and network plus. We propose to review each company's historical and forecast split between these business units to inform this split.

### **3.1 Abstraction charges**

Abstraction charges are charges made by the Environment Agency and Natural Resources Wales for abstraction licences held by water companies. The charge reflects the environmental impact of abstraction. The charge also includes a small element to recover the environmental regulators' administrative costs.

We propose to include an efficient allowance for abstraction charges as part of water resources totex. This will provide companies with an incentive to manage their abstraction licences and licensed volumes efficiently.

To assess an efficient level of abstraction charges we are considering two alternatives. The first is that we include the charges in our benchmarking models, together with the rest of the costs assessed by the model. This was our approach at PR14. The second is that we remove abstraction charges from the benchmarking models and assess it as a separate component of the water resources costs.

We have yet to develop the specification of our cost benchmarking models. But if our models include factors (ie "cost drivers") that explain variation in abstraction charges across companies, then we could include abstraction charges in our models and expect them to deliver robust benchmarking. Such factors may be the volume of water supplied or abstracted<sup>1</sup>, or the number of customers, to which abstraction charges are related.

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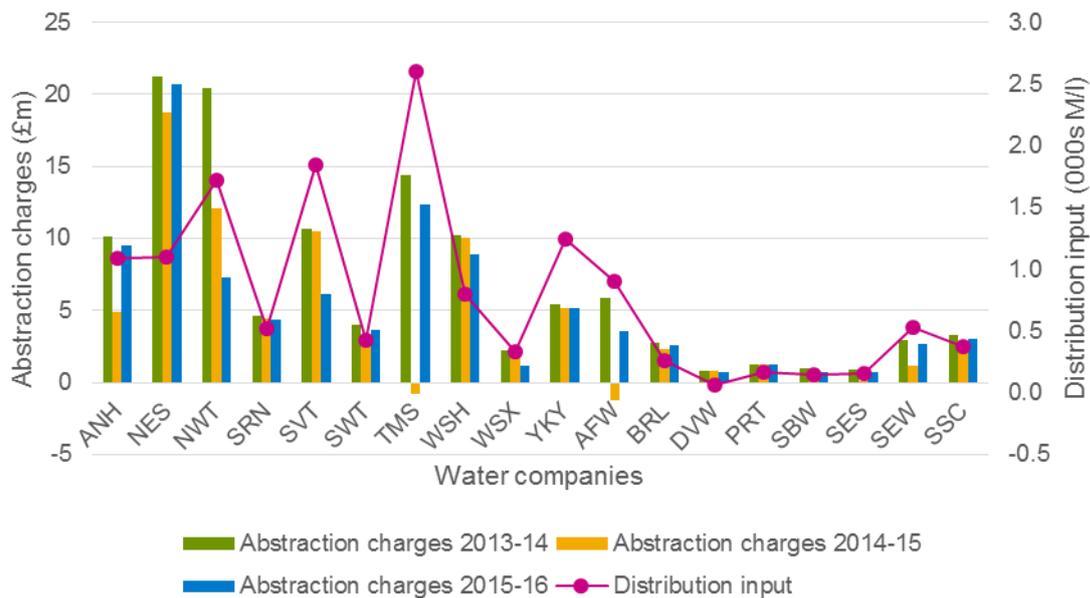
<sup>1</sup> We note that including the volume of water supplied in our cost models may have a perverse incentive for companies not to improve water efficiency.

If, however, variations in abstraction charges cannot be well explained through the volume of water abstracted or any other factor, then including abstraction charges in the models could reduce the accuracy and robustness of the assessment.

This last point is particularly relevant for PR19. Abstraction charges are a material component of water resources costs (around 24% of water resources totex). Given that we propose to develop separate cost benchmarking models for water resources, including them in the models without suitable drivers may have a large effect on the robustness of the model. In the context of the wholesale water models at PR14, abstraction charges were not a material component of costs, therefore did not have the same potential to impact on the models.

Figure 2 shows abstraction charges and water distribution input across water companies. Overall there is a good correlation between the two, with the exception of Northumbrian Water that has relatively high abstraction charges and Yorkshire Water that has relatively low charges. Abstraction charges show substantial year on year variation. Between 2013-14 and 2015-16, companies reported abstraction charges ranging from -£1.2 million to £21.2 million per year. This may be due to the timing and reporting of compensation paid to companies over this period. At the same time there is very little change in distribution input across years.

**Figure 2 Abstraction charges and distribution input\* from 2013-14 to 2015-16 (2012/13 prices)**



\* Distribution input show little year on year variation. For simplicity we display an average value in the figure.

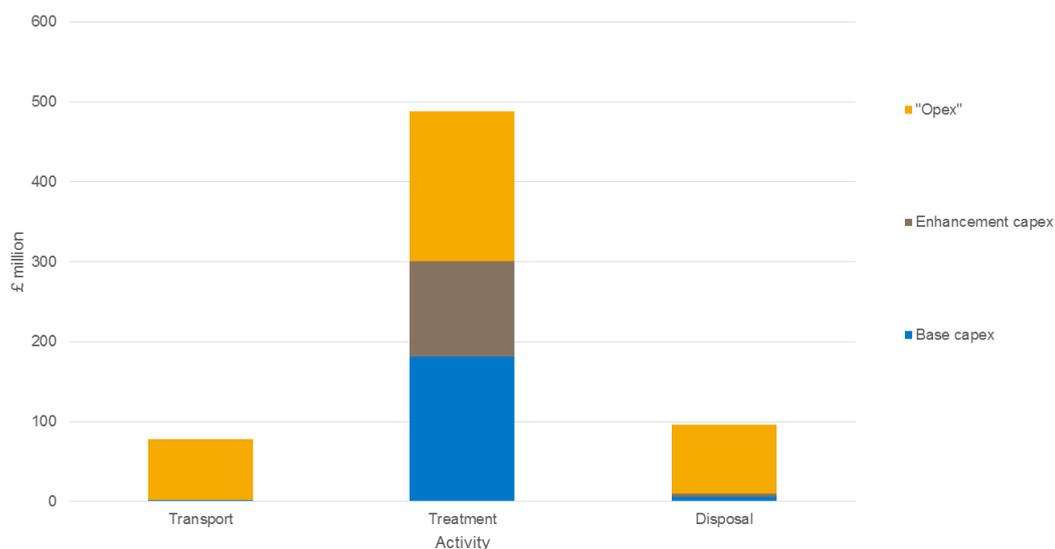
The evidence suggests that there may be benefits to excluding abstraction charges from our benchmarking models and adopting a more targeted approach by assessing them separately.

We propose to assess abstraction charges based on the evidence submitted to us by companies in business plans. We would sense check and challenge forecasted level of charges using comparison of abstraction charges across companies, taking into account relevant metrics, such as volume of water supplied and uncontrolled elements of the charge. If we assess abstraction charges separately, not as part of a wider benchmarking analysis, we do not expect companies to raise cost adjustment claims related to abstraction charges. However, we expect companies to explain why their forecast is robust and efficient.

Do you agree with our approach to assessing abstraction charges?

## 4 Setting efficient expenditure for bioresources

In our [May 2016 document](#) we set out our decision to have a separate binding control for bioresources in the 2019 price review. As part of this control we will set an efficient total expenditure allowance for each company to deliver bioresources services from 2020-25.



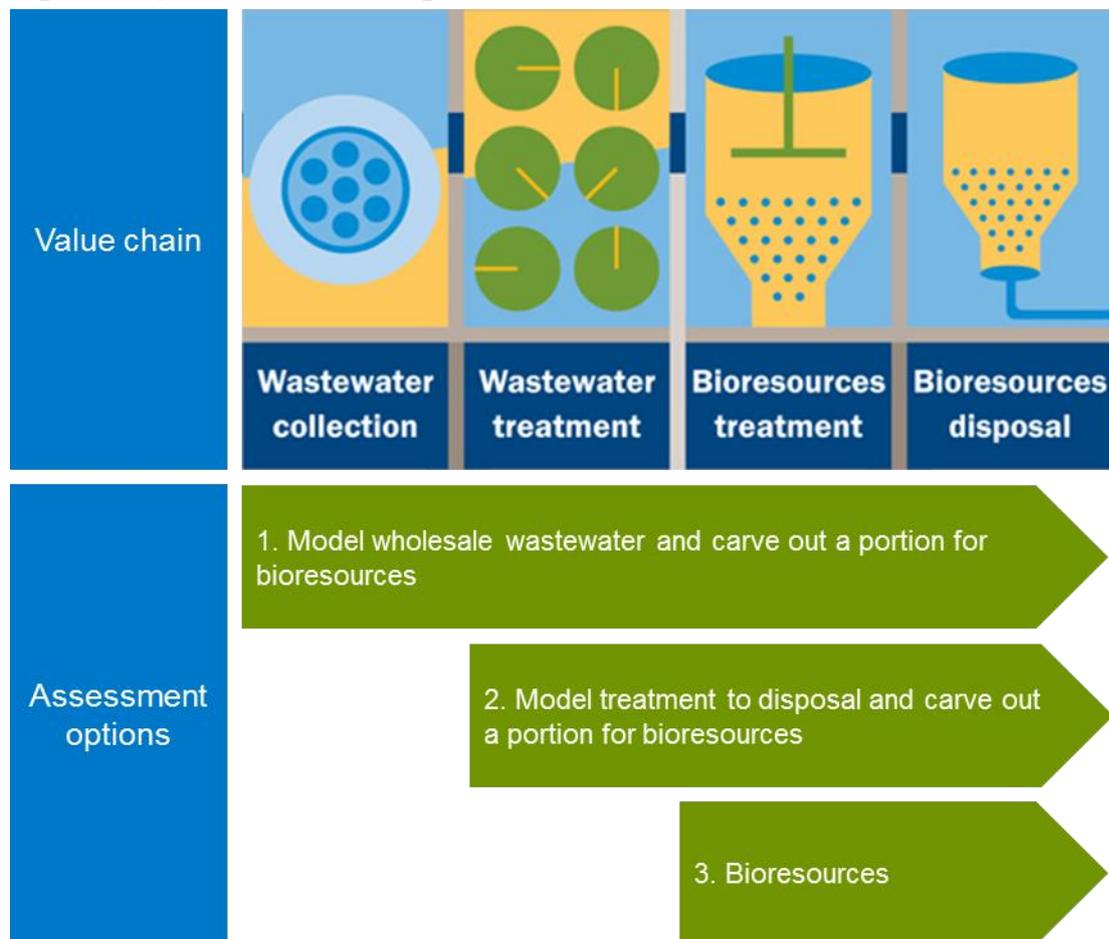
Bioresources expenditure per year is around £660 million a year, or around 16% of wholesale wastewater totex.<sup>2</sup> It includes all costs associated with the transport, treatment and disposal of bioresources – see figure 3.

**Figure 3 Bioresources expenditure by activity, annual average 2011-12 to 2015-16 (2012/13 prices)**

Similar to our approach to water resources set out above, we propose to use benchmarking analysis, with a range of aggregated and granular models to set efficient totex baselines for bioresources. Figure 4 shows three levels of cost aggregation. From an aggregate level where we benchmark wholesale wastewater costs, a middle level that includes bioresources and wastewater treatment costs, to a granular level that includes only bioresources costs.

<sup>2</sup> Based on the latest available data, 2013-14 to 2015-16.

**Figure 4 Options for assessing bioresources costs**



The rationale for keeping a range of options to estimate efficient bioresources costs is the same as for water resources. We note that the middle and aggregate levels are similar to our approach at PR14. At PR14, bioresources costs were included in our wholesale econometric models. One model covered wholesale wastewater base<sup>3</sup> costs (bioresources and wastewater network plus), and another included wastewater treatment and bioresources base costs.

Benchmarking analysis under options 1 and 2 in figure 4 will provide us with an estimate of efficient costs at a more aggregated level than bioresources. To set efficient cost baselines for bioresources, we will have to further split the result between bioresources and wastewater network plus. We propose to review each

<sup>3</sup> Base costs exclude expenditure associated with enhancement activity.

company's historical and forecast split between these business units to inform this split.

#### **4.1 Enhancement expenditure in bioresources**

Enhancement expenditure in bioresources may be required to accommodate growth in sludge volumes. This growth may be either due to population growth or higher quality requirements in sewage treatment, which result in higher volumes of sludge. We do not expect that there will be any new statutory requirements for improved levels of treatment of bioresources in 2020-25 to drive further investment.

Investment in additional capacity to accommodate additional volumes of sludge tends to be lumpy and infrequent. A company can raise a cost adjustment claim for material new investment as long as the claim is robust against the evidence we set out above (see section, Evidence to support cost adjustment claims). Companies will also have to show that they have considered the use of a third party to provide the additional treatment capacity.

For the reason set out above, we propose to include only base costs in our benchmarking models. Any enhancement investment will be assessed separately should the company raise a cost adjustment claim.

## **5 Setting efficient expenditure for residential and business retail**

As outlined in the cost efficiency chapter, we propose to use econometric benchmarking to assess cost efficiency in residential retail. This is different from the average cost to serve (ACTS) approach of PR14. We have been working with the industry to develop our thinking on econometric models for residential retail.

Our proposal to move to an econometric approach is motivated by the fact that in PR19 we will have better and more years of data. In PR14 our approach was based on one year of data. For PR19, we will have five years of data to develop robust benchmarking for residential retail.

In the cost efficiency chapter we also say that if we are unable to produce robust econometric models, we propose to use an efficient cost to serve (ECTS) similar to the ACTS approach of PR14, with higher efficiency challenge. In box 1 we explain the PR14 ACTS approach. We also highlight where we propose to develop this approach should we decide to adopt an ECTS approach.

## Box 1 Summary of the PR14 cost assessment approach for residential retail

### PR14 Average Cost to Serve (ACTS)

- We calculated the companies' costs to serve for all customers as retail costs to serve per "unique customer".
  - Retail costs included opex plus depreciation, but excluded metering costs and any other cost adjustments (see below).
  - Unique customers was the sum of (i) households billed for water only (ii) households billed for wastewater only and (iii) households billed for water and wastewater multiplied by an "economies of scope" factor\* of 1.3.
- Our efficiency benchmark was based on the ACTS, which was the industry average\*\* cost to serve.
  - If we use an ECTS approach for PR19, we propose to set the benchmark based on the most efficient companies rather than on average efficiency.
- Companies were allowed the lower of their cost forecast or the ACTS benchmark.
  - If we use an ECTS approach for PR19, we propose to use our benchmark to set efficient costs for all companies, whether they are above or below our benchmark.
- We made an additional allowance for the additional cost to serve metered customers. The allowance was company specific based on each company's expected level of metering.
- We made additional company specific adjustments where retailers provided robust evidence that material factors beyond management control affected them in a different way to other companies. Where adjustments were made for cost included in the ACTS, this reduced the industry ACTS.
- Companies were given a three-year glide path where their costs were above the benchmark.
  - For PR19, we do not propose to allow a gradual catch-up (glide path).

\* An economies of scope adjustment was made to account for the additional average cost of servicing a dual service (water and wastewater) customer over a single service customer.

\*\* An unweighted average was used, each company's cost to serve had the same impact on the average, regardless of the number of customers each company served.

## **Legacy depreciation**

In PR14 we decided not to have RCV in the retail controls. Retail assets that were invested before 1 April 2015 (“legacy assets”) were remunerated through the RCV in the wholesale price controls.

Companies report depreciation on legacy assets and new assets (ie assets that were invested after 1 April 2015) separately to us. For the purpose of retail cost benchmarking, we will include total depreciation in our analysis. This avoids distortions in our benchmark analysis associated with the timing of different investment decisions across companies. As in PR14, we will then remove depreciation related to legacy assets from our efficient cost baselines, to ensure customers do not pay twice for the same legacy depreciation.

## **5.1 Our proposal on input price pressure for the retail controls**

### **5.1.1 The options that have been considered**

At PR14, we set the appropriate nature and form of retail controls as part of the final determination, as companies licence did not prescribe the form of control. This was different to wholesale controls, where companies’ licences required us to index the limit on the change in charges to the RPI (at that time).

Unlike wholesale, retail is a labour intensive service and there is no RCV to protect from inflation in these controls. Although inflation is outside companies’ control, we consider that inflation risk to retailers is limited within the price control period. We also think that breaking the automatic indexation of the retail price control will provide an incentive to retailers to mitigate this risk to the business, consistent with the incentives in more competitive markets.

Below we consider two options to account for input price pressure faced by residential and business retailers at PR19:

Option 1: Retail controls will not be indexed to an economy-wide measure of inflation. If appropriate, we will make an allowance for input price pressure as part of our totex baselines for retail.

Option 2: Retail controls will be indexed to an economy-wide measure of inflation, consistent with the measure used to index the PR19 wholesale controls.

**Table 1 Options for addressing input price pressure, retail PR19**

	<b>Option 1 - no indexation (status quo)</b> <b>Preferred option</b>	<b>Option 2 - indexation</b>
Achieving our objectives	<p>Customers are protected from automatic increases in bills driven by an increase in an economy-wide inflation measure that does not reflect an increase in the costs of efficient retailers over the price control period.</p> <p>An allowance for efficiently incurred inflation costs can be made as part of the totex allowance to ensure efficient companies are protected.</p> <p>✓ ✓</p>	<p>Customers are protected through the efficient cost allowances we will set for retailers. Our allowance will not include cost against expected inflation.</p> <p>Due to indexation, customers bear inflation risk, even though input costs mainly relate to labour costs and companies can mitigate this risk to the business during the term of the price control.</p> <p>✓</p>
How our objectives are achieved	<p>The option allocates retail inflation risk to companies rather than customers. This provides a strong incentive for retailers to manage their input costs, better reflecting a competitive market.</p> <p>✓ ✓</p>	<p>Provides a weaker incentive for companies to address input costs in their forecasts as risk sits with customers.</p> <p>✓</p>
Practicality	<p>Not indexing retail controls to inflation is easy to implement. However, may require estimation of input price pressure and consideration of whether or not these can be managed in the price control period.</p> <p>✓</p>	<p>Although a change from our PR14 approach, it is consistent with our approach in wholesale so practical to implement.</p> <p>✓ ✓</p>

### 5.1.2 Our assessment of the potential options

We consider that our approach used at PR14 (Option 1) is still appropriate for retail controls at PR19. Not automatically indexing to an economy-wide measure of inflation provides appropriate incentives for companies to manage input costs.

Retailers elsewhere in the economy do not see prices automatically indexed to inflation. Instead, competitive retailers decide whether or not to pass inflation cost on to customers. For example, they may consider this based on the likelihood of

customers switching to a competitive retailer if customer bills increase. This mechanism does not exist for monopoly retailers, so it is important to protect consumers from automatic increases in input prices in the absence of customer switching.

Retail services use a different mix of inputs compared with wholesale, with labour representing a large proportion of input costs. We consider that inflation risk due to labour costs can be managed by companies, and that the risk is relatively low, particularly in the context of a three-year price control period which we consider may be appropriate for retail activities (see the retail controls chapter for detail on this proposal).

Unlike wholesale, there is no RCV in the retail controls which means the issue of indexation only applies to allowed revenue rather than the protection of the long-term value of the RCV against inflation risk. So for retail the relevant inflation risk relates to the risk that input prices increase in the short term.

### **5.1.3 How our proposed approach will work in practice**

We will set cost baselines and revenue for retail, which will not be indexed to an economy-wide measure of inflation. If appropriate, our efficient cost baselines will include an allowance for input price pressure.

Companies will report their assumed retail input prices pressure separately in the business plan tables. Companies should explain any assumptions they have made in relation to forecast input price pressure and explain why these costs are beyond management control during the price control period.

## 6 Enhancement expenditure: approach to funding unconfirmed environmental requirements

We explained in the cost efficiency chapter that there is a mismatch between the five-year price review and six-year river basin management planning (RBMP) cycles. In PR14 this mismatch meant that our final determinations were made a year before ministerial decisions on the scale of the programmes<sup>4</sup> for the second round of the River Basin Management Plans (RBMPs) were made.

To address this mismatch at PR14, and enable water companies to make informed cost forecasts in business plans, the Environment Agency made 'best endeavours' to provide them with the likely scope of the programme required to meet Water Framework Directive (WFD) objectives at a catchment level. No site-specific measures were identified at that time.

Despite this approach there was a considerable difference in measures between the assumptions made for our PR14 final determinations and the NEP released in January 2016. For example, our final determination assumed that Thames Water would be required to carry out first-time or improved phosphorus removal at 40 sewage treatment works (STWs) to achieve good ecological status in the receiving watercourses. However, the final NEP only listed 25 STWs at which such measures were required in 2015-20. In terms of the population equivalent served by the STWs, the quantity of phosphorus removed, and the river length forecast to attain good ecological status, the reduction was proportionately greater. Likewise, our final determination assumed that Severn Trent Water would be required to meet tightened sanitary consents at 20 STWs serving an aggregate equivalent population of 892,000, again to achieve good ecological status in the rivers to which they discharged. By contrast, the final NEP confirmed a requirement for improvements at 15 STWs serving an equivalent population of 419,000.

Though the picture varied from company to company, the evidence from PR14 suggests it is likely that business plans will over-estimate the scale of improvements actually needed by the WFD. Therefore, there is a significant risk that customers will end up paying for a larger environmental improvement programme than necessary.

While cost sharing, performance commitments and outcome delivery incentives agreed at PR14 afford a degree of customer protection, they do not cover all of the

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<sup>4</sup> Known as the Programmes of Measures (PoMs).

environmental programmes in the final determination. As a result customers are not fully protected against reductions in the scale of environmental programmes.

At PR19 the gap between final determinations and finalisation of the programme of measures will have grown by a further 12 months to a total of two years. Consequently, uncertainty surrounding the scale of the enhancement programmes that companies will be required to undertake in 2020-25 is likely to be a more significant issue than it was at PR14. On the other hand, there is also a greater scope to postpone required work to PR24, as the RBMP cycle finishes at 2027, two years into PR24.

Against this backdrop, we have considered a number of options to better protect customers. The options are described and assessed in table 2.

Option 1: We would make an allowance to companies based on our assessment of efficient expenditure for the anticipated scale of the uncertain programme. We rely on 'best endeavours' to anticipate the scale of the uncertain enhancement programme and on agreed ODIs and performance commitments to protect customers. This was the approach at PR14.

Option 2: This involves making a conservative allowance in price limits based on a proportion of a company's proposed WFD-driven enhancement programme that is considered to be relatively certain. If confirmed requirements turn out to be more than what was assumed at PR19 final determination, companies would be able to seek funding for the additional requirements at PR19 as part of the 2024 price review process.

Option 3: This is a variant of Option 2 which entails making no allowance in price limits for unconfirmed environmental requirements at PR19. Funding of requirements that were eventually confirmed would be dealt with as part of the 2024 price review process.

Option 4: We require companies to link unconfirmed schemes to an agreed outcomes and a unit cost adjustment value. We would make an efficient allowance to fund such schemes and use the unit cost value to make an adjustment in the event of variations between the agreed outcome and that actually required and delivered.

**Table 2 Options for addressing unconfirmed environmental requirements at PR19**

	<b>Option 1</b> <b>Allowance for the full scale of anticipated programme (PR14 approach)</b>	<b>Option 2</b> <b>Allowance for a portion of anticipated programme</b> <b>Candidate option</b>	<b>Option 3</b> <b>No allowance at PR19. Confirmed, requirement will be funded efficiently in PR24</b>	<b>Option 4</b> <b>Allowance linked to outcomes and unit cost adjustment</b> <b>Candidate option</b>
<b>Achieving our objectives</b>	Customers are protected ensuring our allowance is efficient and by providing a strong incentive to companies to reduce costs and challenge the scale of NEP requirements before they are confirmed. However, customers may not be adequately protected against risk of paying for schemes that will not be required. Some customer protection is afforded through the outcomes framework and the cost sharing mechanism. ✓	Customers are better protected against risk of paying for schemes that will not be required. Companies are funded to efficiently deliver all their requirements within the RBMP cycle (ie over PR19 and PR24). Incentive to challenge the scope and scale of NEP requirements is reduced relative to Option 1. ✓✓	Current customers are fully protected against the risk of paying for obligations that may not be required. However, pushing all the programme to the first two years of PR24 may have implications on companies' ability to deliver the schemes efficiently, and could create a spike in future customer bills. ✓	Customers are better protected against risk of paying for schemes that will not be required. Companies are funded to efficiently deliver confirmed requirements in PR19. Companies are incentivised to deliver confirmed schemes efficiently, but have weak incentives to challenge scope and scale of NEP requirements. ✓
<b>How our objectives are achieved</b>	We set an efficient allowance. Where schemes turn out not to be required, unspent allowance is subject to cost sharing. Performance commitments and ODIs afford a degree of customer protection. Companies are funded to deliver their environmental requirements. ✓	Reduces the risk that customers pay for non-required schemes by funding only a portion of anticipated programme and using the two-year window in PR24, before the end of the 3rd RBMP cycle, to fund confirmed schemes not included in PR19. ✓✓	Removes any risk that current customers pay for non-required schemes by pushing all the programme to the first two years of PR24. ✓	Customer protection is achieved by linking funding for unconfirmed requirements to an agreed outcome and unit cost adjustment mechanism. The mechanism to protect customers is clear and transparent. ✓✓

	<b>Option 1</b> <b>Allowance for the full scale of anticipated programme (PR14 approach)</b>	<b>Option 2</b> <b>Allowance for a portion of anticipated programme</b> <b>Candidate option</b>	<b>Option 3</b> <b>No allowance at PR19. Confirmed, requirement will be funded efficiently in PR24</b>	<b>Option 4</b> <b>Allowance linked to outcomes and unit cost adjustment</b> <b>Candidate option</b>
Practicality	No departure from tried and tested processes. ✓	May be difficult to determine a proportion of anticipated programme to set an allowance for. ✓	Presents challenges to the delivery of other regulators environmental objectives. Implications for bills and supply chain if entire RBMP3 investment is to be delivered in 2025-27. ✗	Approach requires setting unit cost adjustment values and monitoring to implement adjustments. ✓

This consultation seeks views on the two options we consider are, on balance, preferred to the alternatives, namely options 2 and 4.

Option 2 involves making an allowance in price limits based on a proportion of a company’s anticipated WFD-driven enhancement programme. The actual proportion would be influenced by the factors considered to affect the degree of uncertainty as well as the experience of PR14. For example, we could set allowances to cover a proportion of the anticipated programme for 2020-25 in terms of, for example, river length improved or pollutant load removed. Setting a low proportion, eg 25%, would significantly reduce the risk that customers pay for scheme that will not be required to be delivered, but it also reduces incentive on companies to engage with the environmental regulator and influence the scale of the programme before it is confirmed.

Setting a higher proportion, eg 80%, would reduce some of the risk that customers pay for schemes that will not be confirmed, but can still leave a fair incentive on companies to engage and influence the scale of the programme. There is no presumption at this stage that it should be a fixed percentage; it could well vary from company to company.

We expect that companies would have sufficient time following scheme confirmation to plan and deliver schemes unfunded at PR19 by December 2027, without needing

to commence significant expenditure in the period 2020-25. However, if necessary, a transition programme in the 2024 price review, which would facilitate companies bringing forward investment to 2024-25, could be used to enable compliance with the statutory deadline.

Option 4 involves setting a cost allowance based on the full extent of the unconfirmed programme anticipated by the company as being required by 2025. However, to protect customers, unless relatively trivial (eg the cost of investigations), allowances in price limits against unconfirmed requirements would need to be linked to an outcome and a unit cost mechanism, which would be used to make an adjustment based on the volume of work that was confirmed as required and delivered by the company. Proposals for WFD schemes without this safeguard would not attract funding at PR19.

## **7 Other cost items: pension deficit costs and business rates**

### **7.1 Pension deficit costs**

Historically all companies have operated defined benefit pension schemes for their employees. In recent times the estimates of scheme liabilities have exceeded estimates of assets, giving rise to deficits. The deficits are repaired by additional contributions or deficit repair costs. These costs are separate from ongoing pension contributions, which we deal with in the same way as operating and capital costs.

In 2009 we set a pension deficit recovery period for each company. For some companies the recovery period extends to 2020-25. Information Notice 13/17<sup>5</sup> shows the assumed recovery periods and sets out our policy for the treatment of pension deficit repair costs at PR14 and beyond. We will make allowances for companies to recover remaining deficit in line with the recovery period assumed in 2009. Companies will be allowed to recover 50% of these allowances from customers, in line with our policy in Information Notice 13/17. However, companies will not be allowed to recover remaining deficit from customers after this time. Remaining deficit will fall wholly to management and shareholders to deal with. This will provide a strong incentive for management to find ways to deal with remaining pension deficit costs efficiently, consistent with the incentives in more competitive markets.

### **7.2 Business Rates**

Business rates are rates charged on non-domestic properties such as offices and factories. Cumulo Rates refer to rates on land and buildings where operating assets are held (eg a sewage treatment works). We use the term business rates collectively to include both business rates and cumulo rates.

As in previous price controls, in PR19 we propose to include an allowance for business rates as part of each price control's totex allowance. This will provide an incentive for companies to manage their business rates efficiently and engage effectively with the Valuation Office Agency which determines business rates. We

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<sup>5</sup> <http://www.ofwat.gov.uk/publication/in-1317-treatment-of-companies-pension-deficit-repair-costs-at-the-2014-price-review/>

expect companies to provide a robust explanation of their forecast levels of business rates and what steps they have taken to ensure these are efficient.

In PR14 we treated business rates as a Notified Item in light of the major revaluation that was due to take place in 2017. We propose to adopt a high evidential bar where companies request notified items. We do not propose business rates to be a Notified Item in PR19<sup>6</sup>. We expect companies to act efficiently and demonstrate they have taken reasonable steps to minimise these costs. Companies should explain any change in these costs from PR14.

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<sup>6</sup> See our discussion on managing risk and uncertainty in the Aligning Risk and Return chapter.