PR19 final methodology queries and answers 5 February 2018

A price review is when water companies and their customers create plans for the future that will deliver customers' wants and needs. Our role is to:

- set the framework and methodology;
- check and challenge the plans; and
- set out our decisions on the five-year price, service and incentive package for each company.

We have published our final methodology for the 2019 price review (PR19), setting out:

- our expectations and requirements for companies preparing their business plans to meet the needs of their customers from 2020 to 2025 and beyond;
- how these expectations form the basis for how we assess company business plans;
- the approach that we will use if we need to intervene in those plans to ensure that companies deliver the step change required by customers; and
- how our assessment will flow through into companies' price limits, service commitments and the wider incentive framework.

In the PR19 final methodology we stated that we will run a queries process for specific questions about the methodology. We stated that if a query was raised which we think is relevant to other stakeholders then we will publish the query and our response on our website. This document sets out our response to the second set of queries we have received on the PR19 final methodology. We will publish our response to further queries in due course. Stakeholders should direct any further queries for clarification, corrections or further explanation in relation to our methodology to PR19@ofwat.gsi.gov.uk.

Ref	Topic	Query	Response
8	Financial model	**Query on CPI(H) + RPI wedge calculations within Final PR19 model** I am not sure that the CPI(H) + RPI indexing is working correctly when I am not using the Indexation Override switches. My understanding (as appears to be confirmed by the diagram including within the 'Rulebook' worksheet (rows 1526-1545)) was that when I look at the RCV values calculated for the 50% allocated to CPIH (e.g 'Water Resources'!K748) and the 50% allocated to RPI ('Water Resources'!K887) these initial values as at the start of AMP7 should be the same. In order to achieve this I have changed the formula used within row 103 of the 'Index' worksheet to read (for cell J3 and subsequently copied across): = IF(J3=$J3, J76, I103 * (1 + J101)) This then ensures that CPIH is used as the index up to 31/3/20 and then the CPIH + RPI wedge is used post 31/3/20. I'd be grateful if you could take a look into this change for me please and let me know if you agree with the change I have made.	We agree with the comment, and suggest the following changes to resolve this issue: 1) The wedge between CPI(H) and RPI should be zero for YE 2019 & 2020, this should be adjusted on the 'Sensi' sheet cells by replacing the values and formula in cells 'Sensi!J57:K59' with "0". 2) The CPI(H) + RPI WEDGE INDEXATION block on the 'Index' sheet should be amended. A new row should be added above row 101 with the following formula "= E$76" entered and dragged across linking the cells to 'CPI(H): Fin year average - inflate from base year 2017-18 average' (row 76). (**See screenshot below**) 3) The formula in 'Index!J104' should be amended to "= IF(J103 = 1, J10**1, I104 * (1 + J102))" and dragged across. (see screenshot below**)

<table>
<tr><th>Ref</th><th>Topic</th><th>Query</th><th>Response</th></tr>
<tr><td colspan="4">
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<tr><td>94</td><td colspan="6">CPI(H) + RPI WEDGE INDEXATION</td></tr>
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<tr><td>96</td><td colspan="6">CPI(H) + RPI wedge 2017-18 active</td></tr>
<tr><td>97</td><td>CPI(H): Fin year average - percentage increase</td><td>-</td><td>%</td><td>-</td><td>-</td><td>-</td></tr>
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<tr><td>100</td><td></td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>101</td><td>= E$76</td><td>-</td><td>%</td><td>-</td><td>-</td><td>102.88%</td></tr>
<tr><td>102</td><td>CPI(H) + RPI wedge forecast annual percentage movement</td><td>-</td><td>%</td><td>-</td><td>-</td><td>-</td></tr>
<tr><td>103</td><td>CPI(H) + RPI wedge base date flag</td><td>-</td><td>flag</td><td>1</td><td>-</td><td>1</td></tr>
<tr><td>104</td><td>CPI(H) + RPI wedge cumulative percentage increase</td><td></td><td>%</td><td></td><td></td><td>= IF(J103 = 1, J101, I104 * (1 + J102))</td></tr>
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<tr><td>9</td><td>Capex</td><td>We’re looking for some clarity on the treatment of capital expenditure in the PR19 tables.

In relation to tables WS1, WWS1 and R1, RAG 2.07 (2.3.2) requires that where an asset is used by more than one price control unit, the capital costs should be reported in the price control where the principle use occurs. On this basis, almost all of our proposed AMP7 M&G capex spend (generally IT) would be allocated to wholesale wastewater as, due to its relative size, it is the business unit of principle use. There appears to be no mechanism for allocating any kind of recharge to other price controls to reflect their use or share of expenditure on these assets, with the result that sewerage totex will be overstated with water and retail understated.

We are concerned about the effect this will have on botex modelling, on the basis that our wholesale water totex will not be comparable to WASCs where water is the principle business unit</td><td>In our final methodology guidance we require the Business Plan Data Tables are aligned with the 2017-18 RAGs. The cost assessment data has been collected on a similar basis and therefore companies should have reflected recharges in the reported operating costs. Therefore costs should be reflected appropriately for each business unit. A business unit should either have operating costs or capital charges that are offset by the recharges from other business units.

Therefore whether a business unit it a principal user or not the level of costs should be equivalent – although maybe reported as opex or capex. From a totex, or botex, approach the costs for each company should be appropriate whether or not the business unit is the principal user of shared assets</td></tr>
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Ref	Topic	Query	Response
		or the WOCs. Is Ofwat aware that this is a consequence of the current table design and that this is the basis on which we should report planned totex costs for AMP7?	
10	Financial model	Just to let you know I have inserted an Analytical Review worksheet into the PR19 model so that I can easily “tell the story” of why the model is producing a given set of outputs as we populate it. That led to the previous issue coming to light and also another potential issue with regards RCV additions and how they flow into the model when using the Data Tables mapping tool. My understanding is that the RCV additions balance as at the beginning of AMP7 (e.g. ‘Water Resources’!L1015) should be zero since the opening balance is input and split between “RCV CIPH bf “ and “RCV RPI bf”. This balance would then increase by the Non-PAYG Totex amount, would be indexed at the start of each year and would have RCV depreciation deducted. Using the model with the mapping tool I am finding that I have an opening balance as at the start of AMP7 which is equal to the level of Gross Capital Expenditure in 18/19 and 19/20 due to the way these values are brought into to the model by the mapping tool. I’ve also noted that in the Water Network worksheet a similar issue exists but this time it is the Opex from 18/19 and 19/20 that is being included when using the mapping tool. To resolve this issue I have deleted cells M232, N232, M274 and N274 from the mapping tool.	We agree with the comment - the following changes are suggested to resolve the issue on 'Water Resources'. The changes will also need to be reflected on the remaining wholesale controls sheets: 1) The Water Resources sheet should be amended. A new row should be added above row 410 with the following formula "= Time!E$104" entered and dragged across linking the cells to 'Forecast period flag' 2) The formula in 'Water Resources'!J412 should be amended to "= J405 * J$409 * J$410" and dragged across and down to rows 413 and 414. (**See screenshot below**)

Ref	Topic	Query	Response
		Again I'd be grateful if you could review and let me know if you think the change I made is appropriate.	

401	**OPEX**					
402						
403	**Operating expenditure**					
404	Water resources: Totex					
405	Water resources operating expenditure (amount for totex CR) (post override) - real	[Enter positive	£m	-	-	-
406	Total gross capital expenditure - WR - real	[Enter positive	£m	-	-	-
407	Water resources grants and contributions (price control)	[Enter positive	£m	-	-	-
409	CPI(H): Fin year average - inflate from base year 2017-18 average	-	%	-	-	102.88%
410	= Time!E$104	-	flag	10	-	-
412	Water Operating expenditure (amount for totex CR) (post override) - WR - nominal		£m	-		= J405 * J$409 * J$410
413	Total gross capital expenditure - WR - nominal		£m	-		= J406 * J$409 * J$410
414	Grants and contributions - WR - nominal		£m	-		= J407 * J$409 * J$410

Ref	Topic	Query	Response
11	ODIs	We have a technical query regarding the proposed drought resilience metric as part of the common suite of performance commitments. Working through this new metric, we think there is a potential inconsistency regarding the 25-year averaging in relation to the requirements to use (a) the long-term baseline supply-demand balance and (b) to only include AMP7 schemes. In relation to (a) most WRZs will see a deterioration of the supply-demand balance due to the impact of a combination of factors including growth, climate change and sustainability reductions. Therefore, where there are no proposed AMP7 schemes to be implemented, we would expect levels of service (LoS) to decline over time, potentially to below current levels. This would be	We have reflected on this query and expect to publish an updated definition of "Risk of severe restrictions in a drought" on the PR19 common performance commitment definitions webpage (https://www.ofwat.gov.uk/outcomes-definitions-pr19/) in early February with some worked examples to make the definition easier to understand and apply.

Ref	Topic	Query	Response
		reflected in a 25-year average. As currently drafted the definition only allows for AMP7 schemes can be included. These schemes will improve our LOS such that customers wouldn't experience rota cuts or standpipes in a 1 in 200 year drought. However, beyond AMP7, the long-term trend described in (a) will see a decline in LOS, unless further schemes are implemented, as set out in our draft WRMP. The overall effect is, on the basis of only including AMP7 schemes, the performance commitment level would be expected to decline. We do not think this is the intended to be the case and are seeking clarification and refinement to the definition. We have identified two potential amendments to the definition to alleviate this issue. Firstly, one option would be to adjust the supply-demand balance used in the metric so that only drought-related deficits are considered. Alternatively, rather than the supply-demand balance including only AMP7 schemes, the measure could reflect the full suite of proposed WRMP investments over the 25-year time horizon, thereby avoiding including the unmitigated impact of non-drought drivers on the supply-demand balance. We would be happy to discuss this if what would be beneficial and look forward to your response.	
15	Risk and return	• Appendix 12 – Aligning risk and return. On page 10 - prescribed scenarios, the 5th scenario is ODI performance (including WaterworCX). As Ofwat has a separate scenario for WaterworCX and quotes RORE ranges for ODI's excluding WaterworCX, please can you like to confirm if the	On page 10 - prescribed scenarios, the 5th scenario is incorrectly titled ODI performance (including WaterworCX). This scenario should be ODI performance (excluding WaterworCX (C-MeX and D-MeX)). This is labelled correctly on page 13 of the appendix and in table App26 of the business plan tables.

Ref	Topic	Query	Response
		5th scenario should really be "excluding" and not "including" WaterworCX?	
16	ODIs	ODI calibration By calibration, I mean the levels of reward and penalty. I am particularly thinking of the common ODIs. I am struggling to find anything in the methodology to tell me how to do this. Is this because you expect companies to come up with methodologies themselves? If yes, that's fine (and that is what is implied in Section 3.6 of Appendix 2). But what if we come up with widely different valuations for supply interruptions for example. Is that acceptable to Ofwat? There might be some regional difference in customer perception, but this is not likely to be very large.	In appendix 2 pg 90 we explain that companies should "use a bottom-up approach, which is based on customer evidence" to set their ODI outperformance payment and underperformance penalty rates. We also say that "We will compare companies' marginal valuation amounts, marginal cost information, and outperformance and underperformance payment rates, for the same performance commitments at PR19.We will challenge companies on their proposed outperformance and underperformance payment rates, where appropriate." In appendix 2 pg 98, we also had a section on common ODIs where we clarified that "For PR19 we are not having common ODIs for the common performance commitments so that companies can set their ODIs based on their customer engagement". We also reiterated that "we will compare companies' ODI rates for the same performance commitments at PR19 and will challenge companies on their ODI rates, where appropriate."
25	Data tables	We have noticed in the R1 table that the calculations cells in lines 17 (Demand-side water efficiency Minus net retail expenditure) is showing as a Sum. The definition states "The retail operating costs of providing water efficiency services (as defined in R1 line 15) to residential customers net of any operating costs that are funded by the wholesale business. R1 line 15 minus line 16" We have identified the same issue in R1 line 20 (Customer-side leak repairs Minus net retail expenditure) where the formula currently sums the two lines above when it should be line 18 Minus line 19 For clarity in the R4 line 17 and 20 the table calculation is correct	We agree and have changed the formulae and calculation rules for lines 17 and 20 to reflect the line definitions for these two lines which are correct. This ensures consistency with the same lines reported in table R4.

Ref	Topic	Query	Response
26	Data tables	Please clarify whether WaSCs are required to answer lines 1, 3, 4 and 6 in App 4. Although the lines do reference WoCs, most WaSCs will have some customers who are provided with water by one company and wastewater services by another. Alternatively, are you expecting companies to split out customer research into customers provided with both services, or customers only provided with water. In respect of lines 1-6 in App 4 where a percentage figure is requested, please clarify exactly what is meant by this, are you asking for a forecast percentage of the proportion of customers we think will be happy, or are you expecting us to ask customers whether they expect themselves to be satisfied with the bill level in each year up to 2025.	We are not requiring Water and Sewerage Companies (WaSCs) to complete lines 1, 3, 4 and 6 in Table App 4. Those lines are there to collect information on customer affordability and acceptability for Water-only Companies (WoCs). A WaSC can provide more detail on its customer affordability and acceptability as part of its business plan submission. When we ask for a percentage figure in lines 1-6 of Table App4 we mean the percentage of customers surveyed who consider their water / sewerage / water & sewerage bill to be affordability or acceptable. The table guidance says companies should complete the data for 2017-18 and future years up to 2024-25. We are not prescribing exactly how a company should do this. A company could ask its customers about their views on affordability and acceptability of their bills for each year in 2020-21 to 2024-25 in which case it can fill in separate numbers for each year. Alternatively a company could ask its customers about their views on affordability and acceptability of bills for the 2020-25 period as a whole in which case it would put the same number for each year from 2020-21 to 2024-25. To complete the data for the years 2017-18 to 2019-20 a company is likely to have PR14 evidence on affordability and acceptability if it is not carrying out a survey of affordability and acceptability for those years in its PR19 customer engagement.
27	D-MeX	I have a query about the development of the D-MeX measure. I'm aware that the D-MeX Working Group has been meeting since September to discuss the design of the metrics and survey. However as the pilot is due to start in April, please could you advise to what extent the methodology for D-MeX has been decided upon and agreed, and whether there are any further issues that need to be addressed before the pilot commences.	The focus of the D-MeX pilots that will take place later this year will be on the qualitative part of D-MeX. Part of the work of the provider that we select to run the pilots will designing them in line with the methodology statement. We sent the specification for the invitation to tender (ITT) for the work to design and run the pilots, to the D-MeX working group for comment.
28	Data tables	There are a number of the data tables with green cells marked as 'pre-populated', however not all of	We will input values into pre-populated cells in the data capture system that we plan to release in May 2018 for the business plan tables.

Ref	Topic	Query	Response
		the cells have values in them. We are inputting the relevant values into the cells to ensure that the embedded calculations work as they should. Can you provide information on when / if the cells will be populated and if they will not be populated until submission how will companies be able to assure the complete tables?	
30	Totex	Given the tight definition of network reinforcement that we have applied through implementing the new charges, this will reduce the amount of contribution received from developers to offset expenditure investment in our network. We are keen to understand how this will impact on the PR19 Totex modelling. If the contributions from developers are deducted before the efficiency modelling then, any company which has followed a tight definition of network reinforcement will look inefficient compared to other companies. We would therefore be keen for any Totex efficiency modelling to be undertaken on gross Totex and developer contributions deducted afterwards. On a separate note when we discussed the new charges, we talked about the increase in costs for new mains and it being related to the success of Self-Lay within our region you asked whether the price rise was just on contestable work rather than across both contestable and non-contestable work. I can confirm that our charges for non-contestable work are in fact coming down slightly and the increase is in the contestable elements, reflecting the fact that the work which we now delivers is generally more complicated and costly work, with self-lay providers completing a lot of the off-line new development mains.	We intend to undertake totex efficiency modelling to be undertaken on gross basis (i.e. including developer contributions), and deduct developer contributions when setting an efficient allowance.

Ref	Topic	Query	Response
32	Retail	I have been looking at App 13 and am unsure in which row(s) we should report our non-household trade receivables. We have exited the non-household market and now only raise invoices to external retailers for our wholesale charges. Should we be reporting these receivables and associated accruals within the wholesale section (lines 11 and 12) or in the retail section (lines 3, 4 and 7)?	We consider that as the transaction is from the wholesaler to the retailer, it should be recorded as part of the wholesale trade receivables in lines 11 and 12.