

Information notice

IN 18/02 March 2018

o f w a t

This is a formal document that alerts our stakeholders to a change in the way that we regulate the water sector in England and Wales.

Price review early submissions on 3 May 2018 for performance commitment definitions and cost adjustment claims

In our PR19 final methodology [guidance on business plan tables](#) we summarised the early price review submissions we are expecting from companies before they submit their business plans to us by 3 September 2018. Two of those submissions are due by 3 May 2018. This information notice reminds companies of what we are expecting from them in those submissions and informs companies how they should send their information to us.

The two submissions due by 3 May are:

- performance commitment definitions; and
- cost adjustment claims

Performance commitment definitions

Our [PR19 final methodology](#) explained that we expect companies to submit the definitions of their performance commitments to us on 3 May 2018.

The purpose of this early submission is so that we can review the definitions to check, for example, that there are no inappropriate exemptions in the definitions of companies' bespoke performance commitments.

We also said that our review of definitions would allow us to check that companies are

using the standard definitions for the common performance commitments. Our policy is that companies must adopt the standard consistent reporting guidance and definitions for the common performance commitments. We are therefore only asking companies to confirm they are adopting the standard definitions and reporting guidance for the common performance commitments.

For their bespoke performance commitments only, companies should submit their performance commitment information in this [pro forma](#). The pro forma is similar to appendix 4 of the PR14 final determination company-specific appendices. This includes both: (a) a

short definition of the performance commitment, which we expect to use in the PR19 final determination company-specific appendix; and (b) a more detailed definition which sets out the performance commitment in its entirety (this could be several pages long), which companies might want to publish separately to the PR19 final determination company-specific appendix to give their customers and stakeholders transparency about their bespoke performance commitments.

Our joint targeted review with Water UK will provide consistent reporting guidance and definitions for the common performance commitments. We will also provide standard short definition text for the common performance commitments, which we expect to use in companies' PR19 final determination company-specific appendices. We will circulate the draft short definitions for comment before we finalise them.

For the common and bespoke performance commitments companies should submit this [worksheet](#), which provides a high-level summary of outcomes, performance commitments and ODIs. This worksheet is similar in format to PR19 business plan table App1.

We expect companies to draft their bespoke performance commitment definitions in plain English, to use technical terms and acronyms only where necessary (and define these where they are used). Our review of the draft definitions will include checking:

- the clarity of the definition and whether there is any ambiguity or internal inconsistency;

- the completeness of the definition;
- for any inappropriate exemptions; and
- for any use of aggregation of several sub-measures, which we have ruled out for PR19.

We will provide companies with feedback about their performance commitment definitions before they submit their business plans, where it is appropriate to do so.

We expect to provide this feedback at the end of June or early July to give companies time to adjust their definitions ahead of submitting their business plans on 3 September. Where a company does not want to, or cannot, change its bespoke performance commitment definition in line with our feedback, the company should inform us of this and provide its explanation for its approach in its business plan.

Where a company is still developing a bespoke performance commitment definition and it is not ready for submission by 3 May the company should still include the performance commitment in the worksheet and provide what details it can in the pro forma. A company will need to provide good reasons why it cannot submit the definition of any bespoke performance commitment by 3 May.

Cost adjustment claims

Our [PR19 final methodology](#) confirmed that we will have a cost adjustment process.

The process allows companies to make well-evidenced claims for unique and material costs that are unlikely to be captured by our cost

baselines. Examples may include a new customer-driven investment; an atypically large investment by the company; or regional operating circumstances with significant impact on costs.

In PR19, the adjustment process will be more symmetrical than at PR14, with adjustments that do not only increase cost allowances but also reduce them where appropriate.

We are inviting companies to submit the information that they have to support each cost adjustment claim by 3 May 2018.

The purpose of the early submission of cost claims is to assist our review process. This will help us to reach decisions on cost claims by the end of the initial assessment stage and ensure that customers are adequately protected. This is particularly important given our commitment to provide early certainty for exceptional and fast-track companies in relation to cost adjustment claims.

There will be a high evidential bar for accepting cost adjustment claims made by companies. We have also set higher materiality thresholds than at PR14. We will only consider claims where the expected cost is above the materiality thresholds we set out in the final methodology and repeat in the table below.

Control	Materiality threshold*
Water resources	6%
Water network plus	1%
Wastewater network plus	1%
Bioresources	6%

Residential retail	4%
Business retail	6%

* As percentage of business plan (5-year) totex in the respective control.

We expect any given cost claim to be fully contained within one of the controls above.

Enhancement expenditure

In our PR19 methodology we said that we will develop a number of approaches to deal with different types of enhancement expenditure. Where possible we will use benchmarking analysis. Where there is insufficient data for robust benchmarking, we will use any other relevant information, including company business plans and evidence of market testing, to assess expenditure.

Submission of cost adjustment claims should not depend on the specific approach that we use to assess the enhancement activity. Our cost assessment approach will deliver cost allowances that cover an efficient level of totex for each company, including an efficient allowance for its new statutory and growth enhancement activities. Whether our approach is based on benchmarking analysis or an analysis of business plans, cost adjustment claims should only be submitted where they reflect unique and material company circumstances, which make the company stand out.

Direct procurement for customers

Direct procurement for customers (DPC, as described in chapter 7 of our PR19 methodology) means arrangements where a water company competitively tenders for a

third party (a competitively appointed provider (CAP)) to design, build, finance, operate and maintain infrastructure that would otherwise have been delivered by the incumbent water company.

As part of the early submission of cost adjustment claims, companies should identify and include projects which they expect to meet the £100m whole life totex threshold for DPC, regardless of whether they ultimately intend to put the project forward for DPC or use in-house delivery.

Content of the information

Appendix 11 of the PR19 methodology listed evidence that we expect companies to submit in support of their cost adjustment claims. Box 1 below repeats this information. Not every claim will require all the evidence listed in box 1. It will be for companies to provide the appropriate evidence to support their claims.

For their submissions on 3 May, companies do not have to provide Board assurance. Companies should submit a final and assured version of their cost adjustment claims with their business plans in September.

To help us navigate the information submitted, companies should provide a maximum two-page summary of each claim and the evidence to support it. These two-page summaries should also provide a signpost to any further evidence relevant to the claim (for example, to the evidence demonstrating the need for the investment, the robustness and efficiency of the cost, etc.). We have provided [a template](#) companies may use to summarise each cost adjustment claim.

Unlike our approach to performance commitments, where we will provide companies with feedback about their definitions before they submit their business plans, where it is appropriate to do so, we will not provide specific feedback to companies on their early submission of cost adjustment claims. We may ask companies for further information or clarification where appropriate.

For their business plan submission in September, we expect companies to use similar summaries of any cost adjustment claim. These summaries should cross refer to the relevant business plan table entry in the cost adjustment claims tables. We also expect companies to explain their overall approach to cost adjustment claims. In particular, how they have considered favourable circumstances that reduce their costs to have a balanced approach to raising cost claims.

Process for submitting the information by 3 May.

Companies should email their early submission information on performance commitments and cost adjustment claims to PR19@ofwat.gsi.gov.uk by 5pm on 3 May.

Box 1: Evidence to support cost adjustment claims

Need for cost adjustment

- Is there persuasive evidence that the cost claim is not included (or, if the models are not known, would be unlikely to be included) in our modelled baseline?
- Is it clear the allowances would, in the round, be insufficient to accommodate special factors without a claim?

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

- What incremental improvement would the proposal deliver?
- Is there persuasive evidence that an investment is required?
- Where appropriate, is there evidence – assured by the customer challenge group (CCG) – that customers support the project?

Best option for customers

- Does the proposal deliver outcomes that reflect customers' priorities, identified through customer engagement? Is there CCG assurance that the company has engaged with customers on the project and this engagement been taken account of?
- Did the company consider an appropriate range of options with a robust cost–benefit analysis before concluding that the proposed option should be pursued?
- Is there persuasive evidence that the proposed solution represents the best value for customers in the long term, including evidence from customer engagement?
- Has risk been assessed? Have flexible, lower risk solutions been assessed?
- Has the impact on natural capital and the environment been considered?

Robustness and efficiency of costs

- Is there persuasive evidence that the cost estimates are robust and efficient?
- Is there high quality third party assurance for the robustness of the cost estimates?

Customer protection

- Are customers protected if the investment is cancelled, delayed or reduced in scope?
- Are the customer benefits that relate to the claim linked to outcomes and to a suitable incentive in the company's business plan?

Affordability

- Has the impact on affordability been considered?
- For large investment schemes in particular, is there persuasive evidence that the investment does not raise bills higher than what is affordable?

Board assurance

Does the company's Board provide assurance that investment proposals are robust and deliverable, that a proper appraisal of options has taken place and that the option proposed is the best one for customers?

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7533
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gsi.gov.uk

Printed on 75% minimum de-inked post-consumer waste paper
[March 2018]

© Crown copyright 2015

This publication is licensed under the terms of the Open Government Licence v3.0 except where otherwise stated. To view this licence, visit nationalarchives.gov.uk/doc/open-government-licence/version/3 or write to the Information Policy Team, The National Archives, Kew, London TW9 4DU, or email psi@nationalarchives.gsi.gov.uk.

