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## PR19 final methodology queries and answers 24 May 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 until 31 March 2018 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 five queries (reference numbers 46, 202, 204, 331 and 372) which should have been included in batch seven published on 15 May 2018. Please note that there are no queries assigned to the following reference numbers: 186, 273, 353, 496 and 497.

We published an update to the data tables on [18 May 2018](#). We have also provided water companies with a company specific version of the data including pre-populated data. **Please can we have any final queries or comments about those tables sent to [PR19@ofwat.gsi.gov.uk](mailto:PR19@ofwat.gsi.gov.uk) by 1 June 2018.** If these relate to company specific data then please include 'Review of company specific business plan data tables' in the subject line of your email.

Ref No.	Topic	Query	Response
46	Cost Assessment	<p>In section 2.1 (basis of financial reporting) of the 'final guidance on business plan data tables', companies are instructed to apply 2017-18 RAGs for 2017-18 and all subsequent years.</p> <p>However, From 1 April 2019 all companies will be required to comply with the new leasing standard IFRS16. This standard requires that all operating leases are treated as finance leases, which means replacing operating cost charges with depreciation and interest, and bringing lease assets and debt onto the balance sheet. Does Ofwat recommend that companies should ignore the impact of this new standard when preparing their business plan submission from 1 April 2019 onwards?</p>	<p>We will issue further guidance separately regarding the reporting of operating leases by the end of May.</p>
202	Risk and Return	<p>Our query relates to wholesale tables Wr5, Wn5, WWn7 and Bio6.</p> <p>All of these tables require an analysis of the wholesale WACC by component. However, table 10.2 of the PR19 methodology shows the WACC components for the appointee, but then deducts 0.1% for the retail margin to arrive at the wholesale WACC.</p>	<p>We have not published an early view of what WACC components for a purely wholesale WACC would be. In our PR19 final methodology publication, we nonetheless set out our view for 2020-25 that the cost of capital will be consistent across the wholesale controls. Companies should complete tables Wr5, Wn5, Wwn7 and Bio6 based on their best assessment of the appropriate WACC components which apply to each control, having heed to this consideration, and providing evidence where their views differ.</p>

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		<p>If a company wishes to use the Ofwat methodology WACC for its business plan, how should it complete the components of the wholesale WACC component in the tables? We suggest that a reduction in the nominal cost of equity from 7.13% to 6.88% should generate a nominal wholesale cost of capital of 5.37%.</p> <p>Would this be accepted by Ofwat as being in line with the methodology?</p>	<p>In the March 2018 iteration of the business plan tables we have tried to simplify submission of this data. This has involved providing an extra table to enter appointee WACC components under notional and actual structures, and simplifying the wholesale tables by providing calculations and feed-through (from the appointee table) of those WACC components which should be consistent across all controls (e.g. Total Market Return).</p>
204	Risk and Return	<p>Re line ref: APP 20. The guidance to the cost of debt table states:</p> <p>“Where companies have forward starting instruments we expect companies to report these. Companies should report the start date in the start date column. Please note that this column only applies to forward starting instruments – we do not expect companies to report the start date of existing instruments”.</p> <p>Can Ofwat clarify what other information in relation to a forward starting swap should be included?</p>	<p>Forward swap details should be entered as normal, referring to the business plan table guidance for 'Derivatives', entering information which explains the value of the swap, its interest rate, and what the swap does (e.g. 'pay fixed, get floating') in applicable columns of App20.</p> <p>The column calculating a real RPI coupon is a reference column which adjusts the nominal interest rate to a real RPI one, based on the table assumption, using the Fisher equation. Though the operation referred to (subtracting inflation rate from nominal interest rate) produces a similar result where both figures are small, the Fisher equation is recognised as being more accurate.</p>

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		<p>With regard to the real RPI coupon, the formula in the table is:</p> $\frac{\text{Nominal interest rate} + 100}{\text{RPI} + 100} - 1 \times 100$ <p>Can Ofwat clarify what the product of this represents?</p> <p>I would expect the formula for the real RPI coupon to be simply:</p> <p>Nominal interest rate - RPI.</p>	
331	Outcomes	<p>Our query is about table App 4 and the definition of 'customers who are in debt'.</p> <p>What is the exact definition of this, is it customers who have missed a single payment, or had an unpaid amount outstanding for more than a prescribed period of time?</p> <p>What would this timeframe mean, how much would they need to owe (is there a lower threshold), and do they need to have</p>	<p>Please see the response to query 160 (published in batch 4 on 15 March 2018 <a href="https://www.ofwat.gov.uk/publication/final-methodology-queries-answers-15-march-2018/">https://www.ofwat.gov.uk/publication/final-methodology-queries-answers-15-march-2018/</a>) where we say:</p> <p>'Companies should use the RAG 2.07 table 2.6.1 definition where debt management is referred to as debt outstanding for more than 30 days.'</p>

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		defaulted, or just missed a certain number of payments?	
372	Risk and Return	<p>Please could you clarify your expectations for the need to clarify the requirement for assessing ‘risk and return’ on water trading – appendix 12, section 3.</p> <p>In particular please would you be able to provide further clarification on the following points:</p> <ul style="list-style-type: none"> <li>• What are the risks that Ofwat expect us to model? Is it about existing trades (e.g. risk that we lose them during a drought), or proposed (although we have no proposed trades as dWRMPs for YW and other companies do not require them), or potential new trades?</li> <li>• If potential new trades are to be included, would it be reasonable to use our options list in dWRMP as a starting point?</li> <li>• Same with returns, what would our returns be? Are you thinking about what we may gain – e.g. financially – if we were to trade out to other companies?</li> </ul>	<p>The risks relate to new water trades that are proposed for 2020-25. The risks/opportunities relate to both downside and upside scenarios around the base case in the business plan e.g. actual volumes or utilisation of the trade turn out to be lower/higher than forecast in the base case.</p> <p>Our expectation is that only trading options identified as preferred during 2020-25 in your latest water resources management plan would be included. If there are no options that fall into this category then a zero should be inserted in the relevant field (see below).</p> <p>The business plan table (App 26) requires the financial impacts to be input. This should be backed up by supporting evidence which would include volumes.</p> <p>There are lines in the scenario business plan table (App 26) to record the impacts. If no new water trades are proposed, zero should be input in the table.</p> <p>The business plan table (App 26) requires the quantitative (financial) impact to be input.</p>

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		<ul style="list-style-type: none"><li>• How are you expecting us to report this back – in financial terms, or water resources / MI/d?</li><li>• Where are you expecting us to report this back – given that there are no lines on the data tables for it?</li><li>• Do you require a quantitative (modelled) assessment, or will a qualitative assessment suffice?</li></ul>	