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OFWAT'S METHODOLOGY STATEMENT
Highlights and Initial Reaction

Ofwat has published its long-awaited PR14 methodology and business planning statement setting out how it intends to set price limits for the 2015-20 period including guidance for companies on how to structure their business plans which are due on 2 December.

The key features of Ofwat's proposals are consistent with its earlier consultations. There are, however, some important changes to the details of Ofwat's methodology, described below. Taken with the recent publication of the Water Bill and the announcement that Cathryn Ross will return to Ofwat as CEO later this year, it appears that some much needed clarity around the future regulatory landscape may be emerging.

Important details have yet to be disclosed and, crucially, it is not yet clear exactly how Ofwat will decide whether a business plan is 'enhanced' or not, nor when Draft and Final Determinations will be handed down.

Wholesale price control

Ofwat has confirmed the introduction of totex and that it will use totex menus, which it will publish in 2014, as part of its incentive package. However, Ofwat appears to have backed away from the emphasis it had placed on totex econometric modelling to determine wholesale efficiency challenges, appearing instead to advocate applying a range of different models and combining the results in a yet-to-be-determined fashion. Some companies may welcome the decision to reduce the importance attached to totex modelling, but may not be satisfied with Ofwat's continued refusal to share its totex econometric models with the industry. It is unclear what comfort can be drawn from Ofwat's indication that it will be making the dataset it intends to use available before the end of 2013 and that it will be "fully transparent" in setting cost baselines in 2014.

Companies will, as expected, need to submit proposals for how much of their totex they want to capitalise into the RCV – the Pay As You Go (PAYG) ratio – and the rate at which their RCV depreciates (effectively a representative asset life). Although there may be a temptation to determine these factors based on financeability criteria, companies need to be mindful of how their proposals vary from the positions they may have taken in the past and what their proposals might mean over the long term. For example, consideration will need to be given to what might happen to the 'steady state' RCV under their proposals and to the possible implications for long-term debt financing as a result of trying to offset any anticipated reduction in cost of capital by accelerating depreciation, or as a result of assuming straight-line depreciation for several consecutive price periods, which has the potential to create a revenue 'cliff edge' in the future. This is especially important given that it is clear from the data requested by Ofwat that the long term projections are likely to be subject to significant scrutiny.

> *"....focus on creating strong incentives for companies to submit high-quality plans and on company Boards to ensure appropriate governance and ownership of those plans"*
>
> — Extract from: "Setting price controls for 2015-20 – final methodology and expectations for companies' business plans" Ofwat

Household retail price control

Ofwat has confirmed that it will set household retail revenues based on an industry average cost to serve (ACTS) plus a margin that reflects the risks of the household retail business. Ofwat has decided, however, that companies whose costs are below the ACTS will be remunerated to cover their actual cost to serve, perhaps leading some to question the benefit of being below the average. Companies which are above the average will be able to catch up over a three year period. Ofwat has left open the door for companies to propose adjustments to the ACTS if they can demonstrate that their doubtful debt costs are high due to factors outside of their control, such as bill size or customer incomes.

Ofwat has also confirmed that the household retail price control will not be indexed to inflation. In the absence of compelling evidence, it seems increasingly likely that companies will, effectively, face the additional efficiency challenge of offsetting cost inflation that can't be passed through to prices. Notwithstanding how companies forecast their retail costs, the ACTS will be based on actual 2013-14 costs.

Perhaps the biggest change to Ofwat's approach is the decision to calculate the denominator in the ACTS based on the number of unique customers, adjusted for economies of scope. Ofwat had previously suggested this approach, but had appeared to think it would be too difficult to implement in practice. Ofwat's preliminary analysis suggests that the cost to serve a water and sewerage customer is around 1.3 times the cost of serving a single-service customer, although exactly how Ofwat generated this estimate is not explained.

Customer-side leaks, demand-side water efficiency services and some aspects of developer services have been confirmed as retail activities, meaning that the definition of retail has finally been settled. Aside from giving clarity around the price control, Ofwat's definition of the retail business has wider implications because it is also likely to be the definition used for the purposes of market opening and competition from 2017.

Non-household retail price control

Ofwat has decided that companies will be allowed to set a default tariff for each customer type within a range set by Ofwat, where the different customer types will be determined by a company's existing tariff structure. The default tariffs will also include a margin to compensate for the risks of the non-household retail business, but will not be indexed to inflation.

Recognising that the Welsh Government has chosen not to implement retail competition to the same extent proposed in England, Ofwat will retain an approach to non-household retail price controls that incorporates quality of service incentives (a non-household specific version of SIM) and an efficiency challenge set by reference to the equivalent tariffs offered by English companies.

Financial issues

Ofwat says more than might have been anticipated on cost of capital, setting out views on some specific parameters. For example, Ofwat has indicated that it will adopt a single notional gearing assumption for the industry in a range of 60-70%, higher than at PR09. Ofwat goes on to note that "a lower assumed cost of debt is likely to be warranted for 2015-20" and that "market evidence appears to be consistent with a lower cost of equity than we assumed at PR09", which gives a strong hint that Ofwat will expect companies to propose a lower WACC at PR14 and that they may impose one if they fail to do so.

Elsewhere, Ofwat's interest in the merits of highly leveraged companies has led to limited new proposals: no cap on gearing will be imposed "at this time" and the only concrete action appears to be to monitor the issue through the re-introduction of a 'financial performance' report similar to the one that existed until 2009-10.

> *"a lower assumed cost of debt is likely to be warranted for 2015-20"*
>
> — Ofwat

Ofwat's thinking on financeability also appears to be a work-in-progress. On one hand, there is some helpful guidance about the ratios that it intends to look at and a confirmation it will test financeability at a whole-business level, but then Ofwat muddies the waters by indicating an intention to examine financeability (but not financial ratios) at a price control level, mentioning equity ratios, but failing to make it clear if any weight will be attached to them. Ofwat also provides little clarity about how to solve financeability problems, other than that companies need to consider a range of options including index-linked debt and equity issuance.

Ofwat says relatively little about how to determine a retail margin, but notes that the margins are likely to be different for the household and non-household retail price controls (e.g. due to different exposures to competition risk). Though Ofwat's advisers suggest calculating the wholesale allowed profit by calculating an allowed profit (WACC) for the overall business and then deducting from this the allowed profits for the retail price controls, we note Ofwat does not comment on this itself.

Ofwat also indicates that it will assume that retailers pay wholesalers in arrears. However, more details on the assumed periods for billing and settlement, which will be needed to enable companies to model their costs accurately, will not be provided by the Open Water programme until the end of October.

The statement confirms that Ofwat expects companies to consider and model a range of scenarios in order to inform a view on appropriate sharing of risk and reward between investors and customers. Following some pushback from the industry, Ofwat has re-examined the suite of scenarios it proposed previously, made some of the requested scenarios optional and also given companies the flexibility to put forward more company-defined scenarios if they wish. However, identifying appropriate scenarios, calibrating the assumptions in those scenarios (e.g. appropriate regional economic forecasts or any other adjustments to the forecasts provided by Ofwat's advisers) based on robust evidence and then interpreting the outputs from those scenarios will remain a key challenge for companies over the next few months.

Calibrating the overall incentive package

Ofwat confirms that companies will need to make proposals about their outcome delivery incentives (ODIs), highlighting the outcomes they are striving to achieve and proposing the penalties and rewards that they think should be linked to those outcomes. A key area for companies to consider will be the strength and internal consistency of the various incentives and particularly the interaction between outcome delivery incentives, cost performance (totex) incentives and other incentives such as SIM and leakage – arguably one of the most complex features of the new regime.

More efficient use of water resources

There are also a range of measures included in the methodology aimed at enhancing the sustainable use of water resources including incentives to encourage water trading (rewards/penalties for trading and the introduction of totex to encourage opex-intensive solutions to water resource challenges) and a reputational incentive to reduce environmentally damaging abstractions. With respect to the latter, the Abstraction Incentive Mechanism (AIM), Ofwat has decided that the available data is not robust enough to enable penalties and rewards to be attached to company performance (although companies may make their own proposals in this area).

Business plan guidance and risk-based review

The methodology statement does not contain prescriptive guidance about the content of the plan or how it should be structured. While Ofwat has gone further than in its consultation papers, the statement only provides limited practical guidance on how 'enhanced', 'standard' and 're-submit' classifications will be attached to each element of the plan. Ofwat continues to prefer to reserve its criteria to encourage companies to put forward the strongest plans possible but confirms that companies rated 'enhanced' will have access to a more favourable incentive package (retaining a greater share of cost outperformance), although the details are yet to be unveiled.

Timetable for the price control

One of the major gaps in Ofwat's methodology statement is clarity over the timetable for the review. Companies will need to submit their plans by 2 December 2013 and Ofwat has indicated that they should plan on the basis that they may not receive their Final Determinations until January 2015, but beyond that little guidance has been publically given.

Next steps

It is likely that companies now have as much visibility of the methodology and process as they are going to get. There remain some areas where companies may need to do more work ahead of submission of their business plans including scenario design and modelling, efficiency assessments, cost of capital and design and calibration of the overall incentive package.

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