Muddy Waters

Even after the publication of Ofwat's final PR14 methodology, a good deal of guesswork is still going on, writes Anthony Legg.

Since much of the content of Ofwat's methodology for setting prices for 2015-20 (published at the end of July) has been well trailed, one might expect it to be crystal clear how Ofwat will set prices at next year's price review (PR14) . However, look a little more closely and a number of significant uncertainties emerge:

Â· how will the cost allowances for building, maintaining and operating the network be set?

Â· how will finance ability tests be carried out and any identified problems solved?

Â· how should allowed revenues be converted into actual tariffs and charges?

Â· how will Ofwat assess business plans?

Cost allowances: Ofwat has confirmed that cost allowances will be based on an assessment of total expenditure (totex) at PR14, but it is uncertain just how an appropriate amount of totex will be determined. While Ofwat has now signaled that it will assess costs based on a range of econometric models, not just totex, the absence of any clear guidance from the regulator as to the models it will consider, and how the results from the different models will be combined, throws up a hornet's nest of possibilities.

For example, while Ofwat has watered down the emphasis it intends to place on totex models (compared with its original position in January where these models were the centre piece of its approach), the weight Ofwat will afford these models is unclear. Other models could be used simply as cross-checks, but might also be used to directly generate the range of the "cost corridors" Ofwat has proposed to use to benchmark companies' expenditures.

Companies will need to build an evidence base justifying whatever cost proposals (and efficiency challenges) they put forward, but it is unclear what the outcome will be if a company makes its case based on a different suite of models to the ones Ofwat decides to use. The answer will depend on how deeply Ofwat probes into the details of a company's plan, which in turn depends on the results of its risk-based review. It may be that triangulating cost allowances and efficiency challenges based on a range of approaches and evidence will be the most robust way forward.

Financial issues: cost of capital; retail margins; and finance ability are sure to be some of the most hotly contested areas of the price control, just as they always are. However, unlike in the past, Ofwat has been more restrained about providing guidelines as to how it expects companies to solve any projected difficulties achieving the target credit ratings needed to secure access to capital on affordable terms that arise at PR14.

In PR09 Ofwat stated that it would assume equity injections and dividend cuts to help companies meet target credit rating metrics, but has provided no such clarity this time around. Indeed, it appears to be down to the companies to find solutions (though the suspicion lingers that while Ofwat might not mandate, for example, an equity injection to solve a finance ability problem, a company responding to Ofwat's feedback on its business plan might not have much of a choice).

It also remains to be seen how precisely Ofwat is going to test for financial problems in the first place. For example, it has asked for a range of information reflecting both the actual capital structure (gearing) of companies and a notional capital structure (which Ofwat indicated would comprise gearing of 60-70 per cent, a sizeable increase from PR09),

but does not spell out how it will use this information.

Further, Ofwat's explanation of its approach also gives the impression that it will carry out finance ability tests for each of the wholesale and retail price controls (in addition to tests at a whole-company level), but without looking at specific financial ratios, and that it will examine equity ratios (not just debt ratios as in the past), but without placing any weight on the results. As unclear as this approach seems to be, one thing does seem certain - by assuming a higher level of notional gearing it is more likely that finance ability problems will arise in the first place, meaning the approach to solving these problems will be all the more important.

Tariffs and charges: Ofwat's methodology statement provides little assistance to companies about how to set the charges that customers actually pay to recover the revenue allowed at PR14. However, the methodology has some significant implications for the way charges are set: aside from the introduction of separate wholesale and retail charges, large user tariffs and infrastructure and connection charges are all brought inside the revenue cap set by Ofwat, meaning that the tariff basket model previously used to convert allowed revenues into tariffs needs to be revisited.

An additional wrinkle is Ofwat's decision to allow companies "greater flexibility" to adjust charges within the five-year period to correct for discrepancies between actual and allowed revenues, but without providing any guidance as to what this means in practice. While Ofwat is set to publish a charging consultation in October, it remains to be seen how much detailed guidance will emerge in a timely fashion.

In any event, the upcoming introduction of competition in some parts of the value chain may prompt some companies to try and rebalance tariffs for different activities and customer groups to ensure they are cost reflective. It seems likely the approach to tariffs will need to be considered sooner rather than later.

Assessment of business plans: in this area, Ofwat expanded a little on earlier consultations, though still avoids giving clear guidance on its approach to encourage companies to prepare as high quality business plans as possible (see article below). While this may seem reasonable, when added to the list of uncertainties around its approach, the industry needs to develop robust, well-assured business plans, in an environment that might be better described as translucent rather than transparent. It could be argued that such an environment increases the likelihood of appeals to the Competition and Markets Authority, though we will have to wait and see if any companies are brave - and prepared - enough to take up that gauntlet.

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