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Agenda

Advancing economics in business

Ofwat's final methodology: now for implementation

Ofwat, the economic regulator of the water industry in England and Wales, has published its final methodology and business plan expectations for the 2014 price review. It is now over to the water companies to complete their business plans for submission in December. Here we give an overview of Ofwat's main decisions and some of the issues that companies will need to tackle in preparing the business plans

Soon after completing the last price review in 2009 (PR09), Ofwat reviewed the process by which it sets price limits for the water companies in England and Wales. The review began in 2010 with a series of discussion papers completed as part of its 'Future Price Limits' project. These papers evolved into concrete proposals for setting price limits, taking into account a government review of Ofwat's regulation of the industry, government policy on its future vision for the industry, and proposed legislative changes.[1] This process concluded in July with a methodology statement and business plan expectations document that companies must follow to prepare business plans for the 2015–20 period.[2]

This article provides an overview of Ofwat's main decisions, as set out in the methodology, in three main areas:

- wholesale;
- retail;
- customer engagement and business planning.

It also considers some of the key issues that companies will need to tackle before they submit business plans.

Wholesale

The 2014 price review (PR14) is the first time that Ofwat will set a wholesale revenue control (separate from retail). The change in approach is due to legislative developments, as competition is expected to be introduced to the non-household retail segment of the value chain from 2017 onwards, and to Ofwat's desire to set separate wholesale and retail controls in order to apply targeted incentives to different segments of the value chain.

Ofwat has decided to set separate revenue controls for water and wastewater services. As confirmed previously, the wholesale revenue control will be indexed using retail price index (RPI) inflation, and will be based on the traditional regulatory capital value (RCV) and weighted average cost of capital (WACC) building blocks.[3]

Wholesale cost recovery and cost assessment

Ofwat's methodology confirms the long-expected move away from the separate treatment of operating expenditure (OPEX) and capital expenditure (CAPEX).[4] Following the same route as Ofgem, the energy regulator for Great Britain, Ofwat will set prices based on total expenditure (TOTEX).[5] In practice, this means that X% of TOTEX will be funded through revenue in the year (TOTEX 'fast money'), and (1 – X)% of TOTEX will be funded through the RCV (TOTEX 'slow money'). Companies will need to decide the percentage of TOTEX fast and slow money, having regard to affordability (measured by average bills) and financeability (measured by key financial ratios used by the rating agencies).[6]

Ofwat will now also assess companies' proposals for the baseline level of expenditure on a TOTEX basis.[7] In practice, this means that it plans to use a number of efficiency models (including TOTEX, where robust), and separate efficiency models for enhancement and base expenditure (OPEX and capital maintenance expenditure). Ofwat intends to use this high-level wholesale cost assessment modelling to establish ranges ('cost corridors') or thresholds ('cost ceilings') for the efficient level of TOTEX. The implication is that a company with TOTEX proposals outside of the range will be subject to greater scrutiny by Ofwat.

Taking the output from its own cost assessment analysis, Ofwat will then form a view of each company's baseline level of TOTEX, in a TOTEX menu. Menu regulation aims to encourage a company to reveal the efficient level of costs by providing additional rewards (in the form of a higher share of any outperformance, for example) for companies that propose a level of TOTEX at or below the regulator's baseline view of TOTEX.[8] Ofgem and Ofwat have both moved towards menu regulation for cost assessment in previous price reviews.[9] For PR14, Ofwat confirmed that it will use menu regulation for water and wastewater wholesale services, and that it will require some of the companies to make menu choices (ie, choices on the level of TOTEX required) once Ofwat has published its draft determinations.

Wholesale financial assumptions

Ofwat has confirmed some key assumptions that will be used to calculate the cost of capital. Most of these assumptions are consistent with its approach to PR09. Specifically, it is proposing to:

- use a WACC approach to rewarding risk. The WACC will be applied to the forecast RCV over 2015–20, consistent with the standard regulatory approach. Ofwat will continue to use a 'notional' capital structure in calculating the WACC. While it is proposing to use a higher gearing assumption from a range of 60–70%, this will still result in a gearing assumption below some highly geared water companies;

- continue to use a capital asset pricing model (CAPM) framework in setting the WACC, and to maintain a fixed debt allowance. This is in contrast to Ofgem, which has moved to debt indexation. Ofwat has concluded that fixed debt allowances will provide the greatest incentives for efficient finance.

Retail

As discussed above, in light of legislative changes in the industry (in particular, the introduction of choice of supplier for non-household customers), Ofwat will set retail controls separately for non-household and household customers in the form of a revenue control, rather than a price control as applied in previous price control reviews. The revenue controls for retail will determine the level of retail revenue that companies will be able to add to wholesale revenue, as determined by the wholesale revenue control.

Ofwat will set the household retail revenue control based on the lower of the industry average cost to serve or the company's own cost to serve. However, the non-household retail revenue control will be based on the average revenue per customer type (ie, based on rolling forward the tariffs in place in 2014/15).[10]

The most material departure from its previous approach is that Ofwat will no longer link the retail revenue control to RPI inflation. Instead, the company will be able to pass only the indexation element from the wholesale revenue control through to customers. Over time, therefore, the retail element of total revenue (retail plus wholesale) will reduce in real terms.

Ofwat confirmed that companies are to propose a net margin in the household and non-household retail revenue controls in order to finance the capital employed in the retail business. However, in proposing a net margin for the household retail revenue control, companies are to ensure that they do not receive a return on retail assets twice (ie, once on the retail assets included in the RCV in the wholesale control, and again in the retail control).

For non-household retail, which is expected to be subject to competition in England in 2017, the net margin is to take into account the future investment requirements in retail and the payment terms between the wholesale and retail business. Ofwat has decided that retailers are to pay the wholesale business in arrears for the wholesale element of the customer bill. Payment in arrears potentially reduces the capital employed in the retail business compared with other forms of payment (eg, pre-payment, which is the form of payment in the non-household retail market in Scotland).[11] Ofwat's choice of payment in arrears therefore affects the size of net margin.

Customer engagement and business planning

One of the early changes that Ofwat made to the process for PR14 was to increase the level of customer engagement in business planning. In response, companies were asked to set up Consumer Challenge Groups (CCGs), led by independent chairs, to engage on the company's business plan proposals (including on the development of company outcomes and outcome delivery incentives).[12] Ofwat confirmed that CCGs are to submit a report alongside business plans. The report is to cover the CCGs' views of the strength of the engagement, and the extent to which the business plan put forward by the company reflects the views of customers. The report will be an input to Ofwat's risk-based review of companies' plans.[13]

Ofwat's methodology and final business plan expectations document sets out the areas that it will consider as part of its risk-based review of plans. The document also explains the process by which Ofwat will issue draft and then final determinations. This process will be based on the strength of the companies' business plans—for example, companies that submit plans that Ofwat considers high quality (or 'enhanced') across all four revenue control elements (wholesale water, wholesale wastewater, household retail, and non-household retail) will benefit from an earlier draft determination, the possibility of an earlier final determination, and additional financial rewards (eg, the potential to earn a greater share of cost outperformance). However, if Ofwat decides that one of the areas of a company's business plan requires 'resubmission', the company will have to resubmit that element, and will receive a later draft determination, the possibility of a later final determination, and fewer financial rewards (ie, restricted choices in the TOTEX menu).

Two issues that companies are facing

Assessing the efficient level of costs

Companies' assessment of the efficient level of costs will form a key part of business plan proposals. This is because the degree of challenge to the business plans (as part of Ofwat's risk-based review) will depend on whether the company's cost proposals sit within the 'cost corridors' as to be determined by Ofwat once it has finalised the cost assessment models; however, Ofwat has committed to releasing the base data in the second half of 2013, including the data used to calibrate the main cost assessment models,[14] and to being fully transparent in setting cost baselines in 2014. Companies will then see for the first time how consistent the results from Ofwat's models are with the results from their own efficiency analysis completed for business plans. It will be important for companies to understand the reasons for any differences and whether the results from the different sets of models can be brought closer together.

Furthermore, Ofwat states that its high-level review of business plans will determine whether there is any obvious information that it should take into account when finalising the high-level cost models, corridors and ceilings. For business plans, companies will therefore have to consider other factors such as the extent to which future expenditure is different from past expenditure, and explain any material differences robustly.

Rebalancing charges

For the risk-based review, companies in England will need to show that average retail and wholesale revenue is broadly cost-reflective for each type of non-household customer. Differences in the underlying retail cost of providing retail services to a non-household customer will largely be due to differences in the risk of non-payment (ie, which affects bad debt costs), and differences in the length of time taken for that customer to pay (ie, which affects the cost of financing working capital). Indeed, it is in companies' interests to ensure that the average non-household retail revenue for each customer type broadly reflects the underlying cost of serving that customer type. If this is not the case, companies could expose themselves to cherry-picking from new entrants once the non-household retail market opens in England, as expected in 2017. This is because, if the retail revenue from a customer is materially above the cost of serving that customer—for example, due to not allocating bad debt or working capital costs appropriately across customers—the customer would be easy prey for new entrants. Companies therefore have a limited window of opportunity to rebalance retail and wholesale charges before submitting business plans in December.

Concluding thoughts

The final methodology business plan expectations document marks the end of Ofwat's review of how it will set price limits for PR14. For the next steps in this process, see the box below. Companies have a tight timescale to ensure that their business plans, which are already well under way, are consistent with Ofwat's final methodology for PR14. Although many of the decisions in the methodology will come as no surprise, companies will need to ensure that the business plan proposals reflect an appropriately balanced package for customers. The trick will be to meet Ofwat's technical requirements (eg, the TOTEX efficiency, outcome incentives) while striking an appropriate balance between the proposed level of bills, the cost of capital and proposals to share risk and reward between the company and customer.

Latest timeline for PR14

Ofwat publishes financial model	September 2013
Business plans and CCG reports submitted	December 2nd 2013
Results of Ofwat's risk-based review of business plans	April 4th 2014
Draft determinations and menus published for companies with an enhanced business plan	April 30th 2014
Baselines and draft menus published for companies with a standard business plan	April 30th 2014
Draft determinations published for companies with a standard or resubmission business plan	August 29th 2014
Menus published for companies with a standard business plan	August 29th 2014
Final determinations published (possibility for an earlier final determination for companies with an enhanced business plan)	December 12th 2014

Source: Based on Ofwat (2013), 'Setting Prices for 2015–20 – Delivery Plan', August.

[1] The implications of the Water Bill were covered in the July issue of *Agenda*. See Oxera (2013), 'The Water Bill: A Turning Point', *Agenda*, July.
[2] Ofwat (2013), 'Setting Price Controls for 2015–20 – Final Methodology and Expectations for Companies' Business Plans', July 25th.
[3] Through a licence amendment process, Ofwat proposed to retain the RCV for the wholesale controls, and to continue to use RPI as the basis for indexing wholesale price limits. Ofwat (2012), 'Consultation on Ofwat's Section 13 Proposals to Modify Company Licences', December. Companies subsequently accepted the licence modifications. See Ofwat (2013), 'IB 03/13 Companies accept licence modifications', January.
[4] Previously all CAPEX was added to the RCV, and was remunerated through revenue based on a return on capital. OPEX was funded on a pay-as-you-go basis through revenue.
[5] Ofgem moved towards a TOTEX approach for the 2009 electricity distribution price control (DPCR5). See Ofgem (2009), 'Electricity Distribution Price Control Review Final Proposals', December. Ofgem continues to use the TOTEX approach, as demonstrated in the first gas distribution and transmission controls under the new RIIO (revenue = incentives + innovation + outputs) model. See Ofgem (2012), 'RIIO – GD1: Final Proposals – Overview', December, and Ofgem (2012), 'RIIO – T1: final proposals', December.
[6] However, in response to Ofwat's methodology consultation, credit rating agency, Moody's, explained that a faster pace of expenditure recovery might not necessarily correspond to a fundamental improvement in financial strength. See Moody's Investors Service (2013), 'UK Water Sector's Move to Totex Cannot Address Financeability Concerns', May.
[7] In particular, Ofwat explains that it will develop 'a fully-integrated totex approach to assessing efficient expenditure, based on top down benchmarking (using regression analysis) of water and wastewater costs'. Ofwat (2013), 'Setting Price Controls for 2015–20 – Final Methodology and Expectations for Companies' Business Plans', July 25th, p. 25
[8] Menu regulation is based on sliding-scale incentives. This means that a company will receive more benefits the lower its expenditure proposals are compared with the regulator's view of expenditure.
[9] For example, in DPCR5, Ofgem used menu regulation for TOTEX (called 'information quality incentives', IQI). See Ofgem (2009), op. cit. Similarly, in PR09 Ofwat used menu regulation for CAPEX (the capital incentive scheme (CIS) menu).
[10] The approach to setting non-household retail controls is different for companies operating 'wholly or mainly' in Wales. For them, the non-household revenue control will be based on the company's proposed tariffs, and an upfront non-household efficiency challenge based on a comparison with equivalent tariffs available to customers in England.
[11] The Scottish retail market was covered in the July issue of *Agenda*. See Brown, S. and Sutherland, A. (2013), 'The Clock Starts Now: Customer Choice In The Retail Water Market', *Agenda*, July.
[12] Ofwat's move to outcome-based regulation was covered in the February issue of *Agenda*. See Oxera (2013), 'Getting the Outcome Right for Water Customers', February.
[13] In 'Passenger power', in this issue of *Agenda*, Anthony Smith, Chief Executive of Passenger Focus, argues for customers to be given greater say in how the rail sector is run, in line with what appears to be a growing trend to encourage customer engagement in regulated industries.
[14] Ofwat (2013), 'Setting Price Controls for 2015–20 – Final Methodology and Expectations for Companies' Business Plans', July 25th, p. 86.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Leonardo Mautino: tel +44 (0) 1865 253 000 or email l_mautino@oxera.com

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