Cathryn Ross
Ofwat
Centre City Tower
7 Hill St
Birmingham

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Dear Cathryn,

Consultation on the PR14 reconciliation rulebook

We welcome the opportunity to respond to your publication, 'Consultation on the PR14 reconciliation rulebook'. We hope you find our response helpful in reaching your final decisions.

We have structured our response into two parts. Firstly we have set out our views on the principle of the reconciliation rulebook including our position on the issue of indexation in the CIS RCV adjustment. The second part of our response, attached as an appendix, sets out our views on the specific issues and options presented in the consultation.

Key consultation issues for Affinity Water

Principle of the reconciliation rulebook

We strongly support the principle of the reconciliation rulebook and agree with the objective of providing a clear explanation of how Ofwat will take into account performance over 2015-20 at the 2019 price review (PR19). We fully support any initiative that promotes predictable and transparent regulation because this does foster trust and confidence across the sector and reduces uncertainty for investors, enabling the continued access to low cost finance and ultimately lower bills for customers.

The assessment framework applied in the consultation document is helpful. However, it is not clear how the primary criteria of 'customer benefits' has been assessed in all circumstances. It is difficult to understand how the importance of regulatory predictability, in terms of investor confidence, has been taken into account in assessing overall 'customer benefit'. We think it would be helpful, when publishing the final rulebook, to include your evaluation of how changes to published incentive mechanisms will not lead to greater uncertainty, higher future financing costs and potentially higher bills to the detriment of customers. This is particularly relevant for the indexation in the CIS RCV adjustment.

Indexation in the CIS RCV adjustment

We regard the proposal to adjust the RCV in PR19, on the basis of a change in indexation methodology, as fundamentally poor regulation. While we recognise that the PR14 final determinations were made in accordance with Ofwat's statutory duties and with regard to relevant guidance from the UK Government and the Welsh Government, we question the consistency with the principles of best regulatory practice.

We do not consider that a change in approach is either proportionate or consistent. Ofwat states in its consultation document that the potential future midnight adjustment to the RCV is around 2% and that this adjustment is likely to be outweighed by other adjustments to revenue and RCV from the PR14 reconciliation mechanisms. On this basis, it seems disproportionate to change the approach to indexation when this will be only one of many adjustments that will be applied at PR19.

In terms of consistency, Ofwat acknowledged that a late change to indexation risked creating regulatory uncertainty and so it was decided to retain the approach proposed in the draft determination as the final determination was made in the round. It seems to us that the regulatory uncertainty identified by Ofwat, which it accepts is not in the long term interests of customers, does not disappear because the issue is raised after the majority of companies have decided not to appeal their final determination.

Ofwat also accepts, in the consultation publication, that any of three possible approaches to indexation (including the approach used in the draft and final determinations and enshrined in the published CIS model) are potentially consistent with the PR09 policy. We remain unconvinced of the need to change approach and do not see how any single approach can be considered as more 'correct' than any other.

In light of these considerations we support the option to 'Do nothing'. We believe this achieves the best outcome in terms of regulatory best practice by reducing uncertainty and maintaining predictability as well as minimising the potential for customer detriment. If the option to 'Do something' is taken we would urge you to consider the particular implications for 'Enhanced' companies.

Enhanced status and 'Do no harm'

As an 'Enhanced' company we were able to secure an early draft determination and in doing so benefitted from the 'Do no harm' principle. We feel strongly that the principle should extend to enhanced companies, in relation to the indexation of the CIS RCV. This would be an effective means of demonstrating the positive value of the incentive package for enhanced plans to secure the long term benefits for customers from the development of high-quality business plans. More importantly, it would reinforce the procedural benefits of 'enhanced' status in terms of minimal regulatory intervention.

Yours sincerely,

Christopher Offer
Acting Director of Regulation

Appendix A: Reconciliation Rulebook Issues

Our views on each of the topics are set out below.

We have included detailed comments including proposals to avoid asymmetry in relation to taxation. While we think it would be best to ensure that over recoveries should be adjusted for tax, whilst under-recoveries should not, we recognise in the round that it may be preferable to avoid complexity and adopt a single approach.

A2. Outcome delivery incentives

- We are content with the assumption that the rewards and penalties in the final determinations are stated in 2012/13 FYA price base and further, that these be uplifted to PR19 price base using FYA RPI (Option 1).

- We understand the argument that most ODI rewards/penalties have always been expected to be made as income or midnight adjustments at PR19 so it is not necessary to reflect the time value of money (Option 1).

- Although FD14 was silent on the treatment of tax we think it is correct to treat ODIs on a post tax basis, so that if for example a company earns a reward of £1.0m for ODI achievements, its revenue adjustment should be £1.2m to take account of the 20% marginal rate of tax that it would need to pay on the increment to income (Option 2).

- It follows that if ODIs are to be adjusted for tax, the +/- 2% of regulated equity cap on aggregate ODIs should also be adjusted for tax (Option 1).

- For major scheme ODIs, we are content with the approach that Ofwat set out the principles for the assessment of major schemes, companies report on their performance in their annual reporting and that Ofwat reviews the evidence for delivery at PR19 (Option 2).

- We agree that for Asset Health ODIs that companies should publish further information on the operation of these indices and supporting formulae (Option 2).

- We are content with the proposals for SIM that have been consulted previously, that there be a bonus of +0.5% and a maximum penalty of -1.0% of total revenue and that the weightings of SIM be shifted to a 75:25 balance in favour of qualitative assessment.

A3. Wholesale water and wastewater costs and revenues

A3.2 Totex cost sharing

- We agree that reported totex needs to be adjusted by the items listed in A3.2.1 to ensure a like-for-like comparison with menu totex determined as part of price limits.

- We are content that actual totex be deflated from outturn prices to 2012/13 price base using actual FYA RPI. This has the advantage of simplicity compared to AMP5, which had the complications of actual and forecast RPI, COPI and notified indices.

- It also seems correct to use the weighted average PAYG rates as in the PR14 determinations over the five year period as this is consistent with the way allowed revenues

were set in the first place (Option 3). If instead all adjustments were allocated to RCV it could take many years for them to work through, whilst allocating 100% to revenue could cause large one-off adjustments to customers' bills. We welcome the flexibility however that if companies can make a case for different PAYG ratio, then that could apply instead, if it were in customers' interests.

- We agree that all totex out and under-performance should be adjusted to reflect the time value of money. This ensures that there aren't artificial incentives to make savings early in the period, for instance by deferring expenditures and expected customer benefits (Option 2).

A 3.2.5 Treatment of taxation on totex sharing

- We think tax adjustments should be included, otherwise incentives will be weakened. For example, companies that outperform will likely earn higher profits and have to pay more tax than assumed in price limits. If this is not remunerated, the rewards to outperformance will be lower, hence weaker.

- We are concerned then that the tax adjustment is only proposed for the RCV adjustments. We can see how this could be desirable when it avoids the potential for double allowance for tax where companies overspend on operating expenditure in the period.

- However, this treatment seems to disadvantage those companies that underspend on operating expenditure. Those that underspend will most likely have higher profits in period and pay more tax than was allowed in price controls. Later at PR19, if the amount of underspend shared with customers is unadjusted for tax, the company will have more than the net benefit it has earned from outperformance removed from its future price limits, and this could weaken the incentives to outperform.

- Perhaps a fairer system is to make the tax adjustment for RCV related adjustments and revenue adjustments in the case of under-spend, but not make tax adjustments to revenue in the case of overspend.

A3.3.2 Treatment of taxation in WRFIM

- We are doubtful about the proposal not to adjust WRFIM incentives for tax, as this does not treat over and under-recoveries equally, as follows:

    - If a company over recovers £1.0m revenue, it will likely make higher profits and pay more tax than was assumed in its price limits, £0.2m at 20% rate. The company will have benefitted by £0.8m net. If the full amount of the over recovery is taken away in PR19 the company will have its allowed revenue adjusted downwards by £1.0m. It will have lost out by £0.2m, in addition to any penalties applied through the mechanism.

    - In the opposite case a company that under-recovers by £1.0m will make lower profits and pay £0.2m less tax than was allowed in its price limits. It has benefitted by £0.2m. If £1.0m is added to its revenue, and an allowance for tax, £0.2m added the company will effectively be allowed to recover tax twice.

- Therefore, to avoid asymmetry, over recoveries should be adjusted for tax, whilst under-recoveries should not.

A3.3.3 Treatment of blind year

- We support the proposal that the adjustment at PR19 for the 2020-25 period be made on the basis of the actual revenues between 2015-16 and 2018-19 and the forecast revenues in the blind year, 2019-20.

A3.4 Water trading incentives

- The export incentive needs to provide a balance between ensuring the size of incentive is adequate to bite, whilst at the same time ensuring that customer payments are synchronised with the realisation of the benefits of water trading.

- We believe the consultation has struck this balance broadly right by allowing companies to recover 50% of the lifetime economic profits in the period 2020-2025.

- If instead companies could only recover at PR19, their share of the economic benefits realised in the 2015-20 period then incentives could be rather too small to be effective. Similarly asking companies to wait until the end of the export agreement may push the rewards so far into the future that they become ineffective. The alternative suggestion, that companies recover 50 % of the entire economic benefits in the 2020-25 period could force customers to pay for the benefits of trading well in advance of their actual realisation.

- For the import incentive, and in line with PR14 methodology, we are content that the import incentive be capped to 0.1% of turnover, accruing annually with the cap applying in each year.

A 3.4.3 Inflation, time value of money and taxation

- As the incentives deal with arrangements that could be long term in nature, such as 20 year bulk supply agreements, we think it essential to adjust for inflation and the time value of money. As there were no allowances for tax included in PR14 limits for these items, the adjustments need to be adjusted for tax, to make sure that companies who respond to the incentives by introducing new bulk supplies are not disadvantaged by incurring tax liabilities that are not remunerated.

A4.2 Indexation in the CIS RCV adjustment

- Please refer to covering consultation response.

A4.3 Blind year reconciliation: materiality thresholds

- We are content with the suggestion that adjustments for the ‘blind year’ PR14 mechanisms be made, subject to them in aggregate, meeting the 2% materiality threshold for income adjustments and 0.5% threshold for RCV (Option 2).

A4.4 COPI updates for CIS model

- We agree that it is desirable to make the adjustments on the basis of actual COPI (Option 1).

A5.2 Reconciliation of household retail control

- We believe that the wash-up of differences in performance against the household retail control should happen at the level of actual and forecast revenues, because that way, companies will receive the revenues intended under the control. This might not happen if the reconciliation happened at the level of customer numbers only. Further we agree that it is only necessary to reflect the time value of money if the difference it would make is material.

- As with the WRFIM earlier (section A3.3.2 above) we are doubtful about the proposal not to adjust for tax, as this does not treat over and under-recoveries equally. Therefore, to avoid asymmetry, over recoveries should be adjusted for tax, whilst under-recoveries should not.

Other matters

- We think there could be advantage in Ofwat subjecting its spreadsheets to review by independent auditors ahead of their final publication. This would give assurance to stakeholders that the calculations are working as intended. In addition, the spreadsheets could also be published in draft form which will give companies and other stakeholders the chance to review and comment on calculations before they are finalised.