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7 May 2015

Dear Keith,

Re: Consultation on PR14 reconciliation rulebook

We welcome Ofwat's intention to set out the reconciliation rulebook well ahead of the next price review, as this signals a level of regulatory certainty.

The key issue that arises from the consultation is the proposed PR09 indexation adjustment. It is our view that Ofwat's original approach to adjusting for inflation, as reflected in the Final Determination, was correct and that a change in approach and a further adjustment is not necessary. In summary, the original approach ensured:

- The risk of RPI is consistently passed to companies, with the initial risk at the start of any AMP being equally weighted;
- Companies have managed this risk consistently over a number of AMPs and the original design of the CIS mechanism is consistent with prior rolling adjustment mechanisms and is therefore likely being implemented as intended;
- Any perceived flaw in the mechanism is removed as we transfer to totex in AMP7 which passes this same risk back to companies.

Furthermore, maintaining the rules as previously set out for companies by Ofwat, gives confidence that companies can rely on such rules when developing their business plans at future price reviews.

We also wish to highlight an inconsistency between the proposals Ofwat set out in the FD and the detail in this consultation on how the wholesale revenue forecasting incentive mechanism would work. The FD stated that revenues would be trued up at PR19, while the consultation indicates that in-period adjustments would be made. As licences do not currently allow for such in-period adjustments, we assume that the approach set out in the FD will be followed and the rulebook amended.

We include more detail on the rationale for maintaining the original approach to indexation, our concerns over the wholesale revenue forecasting incentive mechanism, and also our comments on the remaining topics covered by Ofwat's consultation, in the annex attached. We consider it is important that the final rulebook is clear on all aspects of the methodology, for example in the phasing of revenue adjustments or defining materiality thresholds, so that there is no doubt over how the price control will operate.

Your sincerely

Jean Spencer
Regulation Director

Annex

Outcome delivery incentives

Scheme ODIs

We support the proposed approach to assessing delivery of scheme ODIs as it clarifies the evidence that companies should provide to demonstrate delivery, allows companies to deliver outcomes using alternative schemes and confirms that the non-delivery incentive will not apply where the statutory requirement driving the scheme has been removed.

We expect to provide annual reports on the progress of our schemes. In turn, we think Ofwat should commit to providing annual feedback on companies' submissions, confirming delivery where satisfactory evidence has been provided and making clear where it has concerns about non-delivery. This approach would have several advantages: giving companies the opportunity to make good for customers where Ofwat thinks there has been a delivery shortfall; reducing the risk of surprises and disagreement at the next price review; and sharing the burden of work across the price review period. Securing agreement on scheme delivery as we progress through the 2015-20 period delivery will enable accurate calculation of a "shadow RCV" (i.e. RCV after known/projected midnight adjustments in 2020) so that there are no unexpected adjustments and discontinuities in RCV based metrics post PR19.

The consultation hints that penalties will be applied to compensate customers for delays to delivery. The cost performance incentive already takes account of the financing benefit enjoyed by companies as a result of money not spent. Applying an explicit scheme delivery penalty would risk duplicating an adjustment already made in the totex mechanism. It is difficult to understand the extent of this duplication as we do not know the basis on which Ofwat calculated the penalty rate for our delivery ODIs. It would be helpful if Ofwat were to provide us with their calculation.

Rounding

In reviewing the rulebook and associated spread sheets, we see that Ofwat has not enabled the rounding function. We think that actual performance should be rounded to the same number of decimal places as the performance commitment. This would be a consistent approach, and would avoid very small rewards and penalties which could give unhelpful messages to stakeholders.

Wholesale – Totex

Phasing of totex out/under-performance to RCV and revenue

The consultation is silent on the phasing of totex performance adjustments over AMP7; whether the adjustments would all be made in year 1 or phased equally over the five years on an NPV neutral basis. The PR09 CIS mechanism RCV adjustment was all passed into year 1 bills in the first year of AMP6 via a midnight adjustment, while the revenue element was spread over five years. We recommend the same approach be followed for the two elements of the totex incentive adjustment.

The phasing of adjustments is critical for the volatility of customers' bills. If customers' share of performance were to be significant and all paid through a revenue adjustment in year 1 it could cause significant movement in bills in year 1 (when applied) and year 2 (once paid up). Adjustments to year 1 bills from other true-ups could amplify or offset these movements but at this stage it is impossible to know the scale or sign of these adjustments. Research tells us that customers prefer smooth bill changes over volatile ones.

The phasing also has a potentially significant impact on financeability considerations. Ofwat's approach is to consider financeability based on a notional capital structure and before any reconciliation adjustments. However, our plans for AMP7 have to be financeable on an actual basis and we have to take steps to ensure that our business is financeable in every year. It would potentially be against customers' interests to have to take steps to solve financeability difficulties caused by the phasing of payments for totex performance.

We are content with the proposal to use average PAYG rates *as a starting point* for deciding how to allocate the customer share of performance. However, we also support the proposal that companies should be able to propose a variation from the allocation which arises from this approach in the interests of bill stability and to avoid the need for less attractive mitigants for financeability. These proposals might involve a movement from the average PAYG rate or to the phasing of payments. Retaining this flexibility is important if we are to create balanced bill packages for customers at PR19.

Indexation of transition costs

The methodology is unclear on the treatment of transition costs. For the avoidance of doubt this should be set out in the final rulebook and should specify that transition costs are inflated from 2014-15 prices to 2015-16 prices, then deflated back to 2012-13 prices for comparison with cost allowances. This will ensure that the comparisons are being made in a consistent price time base, whilst companies continue to fund the financing cost of the early spend under the transition plan as agreed with Ofwat.

Accounting treatment of energy hedging

As part of adopting IFRS accounting standards, the treatment of energy hedging costs, which are subject to IAS39 fair value accounting, is as yet uncertain and may be treated as either interest or opex. This compares to the prior UK GAAP position where hedge accounting was available and the amount charged to the P&L account was equal to the hedged rate paid. At some point in AMP6 companies are likely to adopt a new IFRS9 standard which should reapply hedge accounting principles similar to those under UK GAAP however, for at least the first two years of AMP6 there is likely to be significant volatility arising from companies' energy hedging strategies. To ensure that companies continue to make the correct commercial decisions, and that the Totex out/under performance is measured appropriately and reflects the underlying reality, elements of hedge volatility should be excluded from assessment of totex under or out performance.

Wholesale – WRFIM

The detail set out in the Final Determination (policy chapter A7) was in line with our understanding as to the revised principles under which the mechanism would work, following correspondence with Andrew Beaver during the autumn. This is that allowed revenues, set by the RPI +/- K factor in the licence, would be unaffected by the WRFIM, given our existing licence does not allow in period adjustments to K in this situation. Instead, there would be an adjustment to the baseline of allowed revenue for the purposes of calculating the WRFIM. How this would work was unclear and has been clarified by the publication of the calculation model (pap_tec201503pr14wrifm.xlxs).

The FD also set out that any under or out performance in actual revenue was still to be trued up in PR19 in the same way as under the existing RCM, subject to any application of the WRFIM and other PR14 ODIs.

However, the model, and the calculation formulae which it incorporates, appear to be carrying forward the assumption (from the initial consultation on the WRFIM, "Consultation on the revenue forecasting incentive mechanism for AMP6", published 30 April 2014) that an in-period adjustment is possible and indeed undertaken, and therefore seeks to adjust the base line revenue in year *t* by the penalty and the out/under performance in year *t-2*. This has the effect of reducing/increasing the baseline for allowed revenue and thereby causing the penalty to be re-incurred (and potentially increased) in year *t* for that originally incurred in year *t-2,* where the revenue has not been adjusted for the previous out/under performance. This can only be avoided by an in-period adjustment to allowed revenue by the company. This is possible in the event of out-performance, where companies can chose to reduce allowed revenue by abating RPI and/or K. However, it is not possible in the case of underperformance, where companies' have no mechanism to increase allowed revenue.

The FD specifically sets out that allowed revenues, set by RPI +/- K factor in the licences, would be unaffected by the WRFIM, which the existing licences only allow (Ofwat) instead to apply to allowed revenues at the next period review, in the same way as existing and other proposed PR14 industry incentive mechanisms.

Therefore this asymmetrical approach to under performance and out-performance is a fundamental flaw in the mechanism. Ofwat need to clarify how companies could "chose to help smooth the effects of unexpected demand variations" where these lead to under-recovery of revenue, and thereby mitigate the penalty that would otherwise arise under the WRFIM as currently devised. An alternative would be that the model could be modified so that the penalty and the out/under performance is not carried forward to year *t* but rather noted for each year and then re-priced to 2019/20 to form part of the PR19 true-up.

The model inputs include RPI data which we assume, as set out in the "RPI" tab, is the actual November to November (basket year) increase, rather than the RPI assumption 2014/15 to 2019/20 set out in the FD. This would be the logical approach but it would be helpful for Ofwat to clarify.

There is a further issue with the model in its application of inflation (RPI) to re-price to year *t* from year *t-2*. The inputs in terms of actual and allowed revenues are required in the price of the year concerned (outturn prices), but the formulae then re-prices the year *t* adjustment as if it was initially expressed in 2012/13 (FD) prices; this has the effect of overstating the adjustment.

We agree with Ofwat's proposed option 1, that in period adjustment for the performance on specific ODI's is made to allowed revenues. What is not clear is how the ODI in period adjustment is then accounted for in the WRFIM calculation – the WFRIM Excel spreadsheet makes no reference to ODI's. We assume this will be corrected in the final version of the spreadsheet.

Water trading incentives

We agree that the proposed option for export incentives strikes the right balance for companies and customers. We note that there should be a review mechanism at future price reviews should the economic profits differ materially from forecast, as this could lead to over or under recovery from customers to pay for the incentives.

We also broadly agree with the proposals for import incentives, although we think there will need to be some scrutiny of import costs. This is because although a company will presumably have selected a trading option because the import costs will be lower than developing additional resources, there could be an incentive not to negotiate hard on price in order to maximise benefit from the incentive.

PR09 reconciliation

For the reasons set out below, we consider that Ofwat's original approach to adjusting for inflation was correct, as reflected in the Final Determination, and that a different approach and a further adjustment is not appropriate.

It has long been accepted that the risk that actual RPI is different from assumed RPI in any given Final Determination is passed to companies. For instance in setting an allowed cost of debt, nominal debt costs are adjusted for assumed RPI and companies are exposed to the risk that actual RPI is higher or lower than this. If actual RPI is higher than assumed then the total allowed cost of debt will be higher than the nominal cost of debt forecast. Indeed during the Thames IDoK Ofwat explicitly considered whether adjustment should be made based on the high RPI experienced, however no adjustment was made either as part of the IDoK process or during PR14. Therefore, the precedent remains that the risk of RPI is fully borne by the companies and their investors.

Whilst AMP5 is the first time the CIS mechanism has been applied, this can be considered a continuation of the prior mechanisms applied to clawback capital outperformance and the log up/down for COPI. Indeed in prior AMPs companies were allowed to keep capex outperformance within their RCV for 5 years which at a Vanilla WACC rate of c.6% applied in past AMPs equates to approximately the 30% incentive allowed under the CIS mechanism. In this way the CIS mechanism is not new but merely the formalisation of the prior mechanisms to enhance market understanding of the rewards available. Looking back to how these mechanisms were applied in the past shows that the application of the current CIS is entirely consistent with the past. The risk of RPI being higher or lower than assumed was never adjusted and therefore in individual years companies will have incurred rewards and penalties based on this risk exposure. Whether this is now perceived as a design flaw (based on an exceptional divergence of RPI and COPI) does not mean the incentive design is not being applied as originally intended and therefore to retrospectively adjust one AMP is inconsistent.

Having managed this risk over a number of AMPs, the position at the start of AMP5 was that there was actually a significant risk that RPI would be lower than assumed (RPI was negative during 2009 and the risk of continuing low inflation was material). This risk was accepted by the companies as part of the PR09 acceptance of the Final Determinations and managed by the companies throughout AMP5.

Looking forward, the introduction of Totex in AMP6 removes the adjustment for COPI and therefore any perceived flaw in this mechanism is removed going forward. However, if one believes that, as in the past, companies' capex programmes will in reality continue to be exposed to COPI (or at least that inflation affecting capital investment will be different from RPI) then this risk will continue to exist for companies. Indeed were AMP6 RPI and COPI to similarly diverge as for AMP5 then companies would be expected to outperform on their capex programmes. Therefore the CIS mechanism as currently applied is consistent with the likely application of a Totex mechanism in the future.

In summary:

- The risk of RPI is consistently passed to companies, with the initial risk at the start of any AMP being equally weighted;
- Companies have managed this risk consistently over a number of AMPs and the original design of the CIS mechanism is consistent with prior rolling adjustment mechanisms and is therefore likely being implemented as intended;
- Any perceived flaw in the mechanism is removed as we transfer to totex in AMP7 which passes this same risk back to companies.

We believe that the approach Ofwat originally took, and which was set out in Ofwat's approach to the CIS incentive in 2012, was correct. If the methodology is changed now, this undermines the confidence that companies and other stakeholders can take from the ex-ante publication of a rule book, and in our view would be inconsistent with previous mechanisms.

COPI

We agree with Ofwat's proposed solution of using the existing COPI index. However, we agree that the risks identified by Ofwat around how the CIS mechanism operates may well materialise. In this circumstance, we also agree with Ofwat's proposed solution of using a similar index, which should be an appropriate measure of construction price inflation.

Household retail

In general we agree with the options and approach as set out in the consultation. However, we think that Ofwat should set the materiality threshold in the treatment of time value of money. To fail to set a threshold at the outset of the period undermines the purpose of an ex ante rulebook, and companies should be aware of the scale of potential adjustments ahead of Price Reviews.