

Consultation on the PR14 reconciliation rulebook

Introduction and general comments

This is Bournemouth Water's response to Ofwat's consultation on the proposed PR14 reconciliation rulebook. We strongly support establishing a clear and transparent framework underpinning the reconciliation process. Historically the mechanics behind such processes have not always been transparent and we welcome both Ofwat's approach and the opportunity to comment.

We comment here on the proposals contained in the consultation document and the rulebook itself. We do not make any observations on the suite of supporting documents and models.

While we do not agree in all cases, we broadly support the proposals as being reasonable and pragmatic. However companies are to a degree playing 'catch up' to fully understand the rationale behind the proposals and in some areas of the consultation we have found this difficult. Where this is the case we have given our own interpretation and our opinion of that. In view of this we will be happy to discuss any of our comments further.

This document follows the order in which the areas are presented in the consultation document.

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Outcomes

A2.2: Treatment of inflation

We agree that Option 1, using lagged November to November RPI is the appropriate approach to take.

A2.3: Treatment of the time value of money

We do not agree with the proposal to adopt Option 1, to not adjust ODIs for the time value of money.

The consultation recognises this option creates the risk of a perverse incentive that may not encourage behaviour that is the best interest of customers and this is why we disagree with Option 1. It is also contrary to assessment criterion 4 (risk of perverse incentive).

It could be considered a reasonable expectation that customers are aware that the time value of money is implicit in their bills. References to inflation were made throughout PR14 customer engagement processes, and while this may not have been made specifically in

relation to ODIs customers are nonetheless aware of it; therefore the time value of money should be accounted for in ODI adjustments.

In our opinion Option 2, which is also consistent with other areas of the rulebook, is preferable.

A2.4: Taxation

We agree in principle that Option 2, providing a tax allowance for all ODIs, is an appropriate approach.

We note that the consultation does not comment on the proposed tax rate. For transparency and to avoid any future uncertainty the final rulebook should state the applicable rate. For consistency with other PR14 processes we suggest that it should be 20%.

A2.5: Aggregate ODI cap and collar

We are unclear on this proposal.

However we agree that there should be consistency in methodology across the rulebook. As Option 1, where the 80% factor is not applied to rewards and penalties, is consistent with the treatment of tax for ODIs we accept that the proposal is an appropriate approach.

A2.6: Scheme ODIs

We agree that Option 2, setting principles that will apply to the assessment of major scheme ODIs in PR19, is appropriate.

We welcome greater definition of what a 'high burden of proof' to demonstrate the delivery of a project will entail and the examples given are helpful. Future uncertainty or confusion can be avoided if information relating to expectations is provided and we support this and any further move to lay out information expectations.

The aim behind the comment *'in case of inconsistencies, the final determination document takes precedence over any additional documentation'* is unclear and suggests an approach that could be inflexible. The definition of 'any additional documentation' is also unclear and therefore it is difficult to provide further comment. For the avoidance of doubt we would welcome clarity of the scenarios that have been foreseen where such a caveat would be required.

A 'higher burden of proof' is referred to in relation to the dis-application or adjustment of a non-delivery ODI. We agree that this hurdle should be higher and again encourage further clarification of what providing this will entail.

We will report externally audited progress to the Bournemouth Water Customer View group on a regular basis and suggest that examples such as this, and any subsequent reports to Ofwat (either by Customer View or ourselves), should form part of the evidence base.

A2.7: Asset health ODIs

Our approach to ensuring transparency regarding the operation of this ODI has been to take ownership and introduce the following control measures:

- Setting out measurements and methodologies for each indicator within the Data Dictionary (which has been significantly enhanced from the version submitted to Ofwat in our Draft Determination representation October 2014)
- Use of the reference levels set at PR09
- Use of independent technical auditors to review and provide comment on performance
- Sharing of the Data Dictionary and reference levels with the Customer View group and the independent technical auditor
- Facilitating face to face access between the Customer View group and the independent technical auditor.

However we appreciate that, given the importance of the subject, Ofwat wishes to be assured that asset health cannot potentially be compromised as a result of a lack of transparency. Therefore we are happy with the proposal in Option 2, requiring companies to publish further information on the operation of these indices and supporting formulae.

A2.8: SIM

We acknowledge the information relating to SIM laid out in the consultation document.

Wholesale totex

A3.2.1: Definition of totex for menu sharing

We agree with the adjustments proposed in the consultation.

We note the reference to the change in accounting treatment on shared assets and will welcome further clarification of the requirements in due course.

General comment and question

To date, our understanding of the application of the totex menu-sharing is that full autonomy will be given to companies to make investment decisions in the way they feel is most appropriate to the operation of the business and the interest of customers.

However we remain unclear whether this autonomy will extend to the reallocation of a proposed spend for which an ODI is attached. For example:

- An ODI requires capital spend to reach target performance

- However, an alternative, cost-beneficial use of the funding is identified and the company agrees with its CCG (or equivalent), that it is in customers' best interest to allocate the intended totex spend for other activities
- The performance commitment is therefore not met and the ODI penalty is applied
- However: we query whether there be any form of expectation that the allocated funding will be returned to customers (effectively in the same way as a log-down), or will the reallocated spend be viewed 'in the round' of totex spend?

We would welcome clarification of this point.

A3.2.2: Indexation

We agree that the proposal to deflate actual totex to the PR14 2012/13 price base using actual RPI is appropriate.

We cannot see that the definition of 'actual' RPI appears to be in either the consultation document or the draft rulebook. We assume that in line with P&L items that it should be year-average, but would welcome clarification.

A3.2.3: Allocation of totex out/under performance to RCV and revenue

Instead of the automatic application of a mechanistic approach we are inclined towards Option 4 in preference to Option 3. In our view this is the best option to encourage full consideration of customers' best interests.

However we appreciate that Option 3 is more in line with the assessment criterion 7 (straightforward and clear to implement). We also acknowledge that companies will be permitted to justify why a change away from using weighted average PAYG would be better for customers. Therefore we agree that Option 3 is a pragmatic alternative.

We comment however that when applying the weighted average 2015-2020 PAYG ratio consideration should also be given forecast bill profiles in the 2020-2025 control period, to avoid unintended and potentially unacceptable bill impacts.

A3.2.4: Treatment of time value of money on totex sharing

We agree that companies should not be incentivised to exploit timing differences and should be neutral to the timing of expenditure.

Option 2, to adjust all totex out and under performance for the time value of money, is appropriate.

A3.2.5: Treatment of taxation on totex sharing

The proposed option is difficult to understand and lacks a degree of transparency and we are unsure of the full implications to both customers and companies.

We appreciate the difficulty of deriving an appropriate mechanism however believe that it will be fairer to both customers and companies to transparently reflect the full impact of any over or under spend within a tax adjustment.

We suggest that a preferable approach is to explore the issue further with companies and we would be happy to discuss it further. While this may delay the finalisation process slightly we do not feel this should be an issue, considering the 5-year timeframe.

WRFIM

A3.3.1: Treatment in WRFIM of revenue from in period ODIs

We are unclear on this proposal as the consultation text on page 40 refers to including revenue changes relating to in-period ODIs, whereas Table 2 on page 7 refers to excluding them.

However, we interpret from the text that the intention behind the proposal is to:

- adjust allowed revenues for companies with in-period ODIs so that they will receive the Final Determination allowed revenue \pm the net ODI value
- do the above ensure to that pre-ODI allowed revenues do not become distorted either up or down, thereby
- maintaining the original incentives within the WRFIM for the companies to manage their forecasting, and
- replicate how the AMP6 allowed revenues for companies without in-period ODIs will be treated at PR19.

If we are correct in our interpretation then we agree that this is an appropriate approach.

A3.3.2: Treatment of tax in WRFIM

We agree that Option 2, to not include a tax adjustment on the revenue changes that result from WRFIM in PR19, is appropriate.

A3.3.3: Treatment of blind year

We agree that the proposal to make an adjustment in PR19 for the blind year, based on forecast outturns is appropriate.

Water trading incentives

We do not have any comments to make on the proposals.

Reconciliation of PR09 incentives

A4.2: Indexation in the CIS RCV adjustment

We note and accept Ofwat's proposals regarding the indexation in the CIS RCV adjustment.

A4.3: Blind year reconciliation: use of materiality thresholds

We do not agree that Option 2 is appropriate or that it is consistent with the final determination or other documents (assessment criterion 3).

As this is an PR09/AMP5 true-up it should be consistent with other AMP5 processes; that is, that there should be no materiality threshold and all adjustments should be fully reflected. This should not be an onerous process for companies or Ofwat.

Therefore Option 1, adjust each of the mechanisms in full in PR19, with no threshold for materiality, is our preferred option.

A4.4: COPI updates for the CIS model

We agree that Option 1, to adjust COPI in the CIS models when the updated data becomes available, is a pragmatic and appropriate approach.

We note that this means that the CIS true-up is unlikely to occur in 2016, but agree that this is manageable. However we query whether a date should be set when a final decision is made as to how to manage and/or resolve the situation if an updated COPI number is not available before the onset of the PR19 process. We suggest that this should be set with a mind to give Ofwat and companies time to discuss and address the issue.

A4.5: The treatment of PR09 reconciliation adjustments in the PR19 review

We note and accept the proposal for the suggested approach.

Household retail

A5.2: Reconciliation of household retail control

We agree that Option 2, to wash-up any differences between actual and forecast revenues at the end of the control period is an appropriate approach.

However, reconciling without some form of materiality threshold will not be consistent with other PR14 reconciliation tools and so we are uncertain why the assessment of the various options shows that it is.

While we appreciate the rationale behind Ofwat's concern over incentivising companies to accurately match revenues in each year we suggest that to be consistent with other PR19 this should be considered.

A5.3: Treatment of the time value of money

We agree that if a company manages its revenues then the wash-up differences at the end of the period should be small, hence our reason for suggesting a materiality limit above in A5.2.

A5.4: Treatment of tax

We agree that companies should not stand to benefit from a double allowance for tax, and therefore agree that Option 2 is both appropriate and consistent with other approaches in the rulebook.

Gainsharing

We note that it will be our responsibility to ensure that our gainshare work with our Customer View group will not cause issues with the operation of any other mechanisms specified in the reconciliation rulebook.

We also note Ofwat's offer to engage with us to work constructively with us.

We welcome this pragmatic approach and look forward to working with Customer View and Ofwat in respect of the implementation of gainshare proposals.

PR14 - Rulebook

We make the following comments regarding the rulebook itself.

- We support the principle of the rulebook and appreciate the level of detail that is laid out.
- Where the location of the required data may be subject to interpretation it would be very helpful to have greater clarification as to the location of the source data. For example the PR09 Revenue Correction Model contained BON numbers to direct users towards the correct data.

If there are cases where such direction could be given, in particular when data is required to be extracted from models, this would help to avoid any future inadvertent error.

- We note that the examples provided on page 17 of the document are provided to illustrate the working of the ODI calculation model, however also note that this is not reflective of the structure two of our ODI rewards. Our interpretation of the limitations listed on page 10 is that this is not an issue and that the model itself (via line 19), or an offline calculation, will allow us to manage this.

Summary

To summarise:

- We strongly support the initiative to ensure that at PR19 the process for reconciling PR14 is transparent and understood

- While we do not agree with all proposals and so have made alternative suggestions, the consultation is broadly reasonable and pragmatic
- There are a number of areas where we believe further clarification would be helpful and we would be happy to engage with Ofwat further on these areas if it would be useful
- We will welcome ongoing dialogue with Ofwat as the control period progresses.

*Bournemouth Water
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