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PR14 Reconciliation Rulebook Consultation response
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7th May 2015

Dear Ofwat,

Thank you for the opportunity to respond on this consultation.

We support Ofwat's decision to publish a PR14 reconciliation rulebook, which we consider will be a useful tool in the PR19 price determination process and help to reduce regulatory uncertainty. We believe Ofwat's approach of consulting on these proposals at a detailed level is right, as the eventual financial impact of technical decisions on the calculations of these mechanisms may be significant.

In our response to this consultation we have considered which approach best serves the interests of our customers, whilst also providing a fair and even-handed outcome for our other stakeholders.

Whilst we welcome the certainty that the rulebook provides, we consider that it still may be appropriate for a degree of flexibility in respect of allocation between revenue and RCV impact to be incorporated into the eventual application of these adjustments, to ensure an overall fair package for customers at PR19. To this end, we suggest that companies may propose adjustments to the stated calculations, which could be reviewed and subject to comment by customer challenge groups, before Ofwat makes its determination.

In the event that the CMA redetermination of Bristol Water's PR14 price control results in a different approach to any of the reconciliation mechanisms being required or different assumptions used in the inputs, we ask that the rulebook and supporting spreadsheet models are updated to take account of this. It is important that Bristol Water and Ofwat reach an agreed view on the operation of such reconciliations and the assumptions within them as soon as possible after the conclusion of the CMA process.

We welcome the publication of the supporting calculation models provided with this consultation, which have aided clarity over the impact of the proposals. We suggest that final versions of these and all other calculations set out in the rulebook are published alongside the rulebook.

We set out our views on each of the proposed reconciliations below. Please contact us if we can be of any further assistance.

Yours Sincerely,

Mike King
Regulatory Director

1 Outcome Delivery Incentives

1.1 Indexation

1.1.1 Ofwat Proposed Approach

Ofwat proposes to use lagged November to November RPI to inflate in-period adjustments, and to use actual year average RPI to inflate PR14 values to PR19.

1.1.2 BW Comment

Whilst Bristol Water does not have any in-period ODIs in AMP6, we consider that the approach to these will set precedent for the future controls and may impact companies' decisions on whether to implement in-period ODIs in future.

We agree that using actually November RPIs for in-period adjustments is a preferable approach to using forecast RPI. This will provide consistency with wholesale tariff calculations and those in the WRFIM. However, we consider that the approach to in-period and end-of-period ODIs should produce the same net result, as it was not set out during PR14 that different approaches would apply. Therefore, a correction should be applied at PR19 to take account of any differences resulting from the use of November rather than year average RPI.

For end of period adjustments, we support the use of actual year average RPI to inflate PR14 values (set in 12/13 prices) to those at PR19 (expected to be set at 17/18 prices).

1.2 Time Value of Money

1.2.1 Ofwat Proposed Approach

Ofwat proposes to not adjust for the time value of money to account for the difference between when rewards or penalties are earned, and when they are incurred.

1.2.2 BW Comment

We consider that in light of the approach taken for calculation of rewards and penalties at PR14, Ofwat's proposal not to adjust for the time value of money in ODI performance is appropriate at PR19. Our ODI reward and penalty rates assumed payment at PR19 at the rates proposed, with no adjustment to take account of which years the rewards and penalties were earned. Ofwat's proposal is therefore consistent with our calculation.

1.3 Taxation

1.3.1 Ofwat Proposed Approach

Ofwat proposes to allow taxation on ODI rewards and penalties as part of the PR19 review.

1.3.2 BW Comment

We do not agree that an allowance for taxation on ODI rewards and penalties is appropriate. We believe that option 4 is the most appropriate approach, whereby PR19 revenues are not adjusted to take account of the tax on ODI rewards and penalties. This is because the proposed rewards and penalties are calculated based on customers' willingness to pay for the service improvement, with the willingness to pay being the full value of the improvement rather than a value grossed up for tax.

1.4 Aggregate Cap and Collar

1.4.1 Ofwat Proposed Approach

Ofwat proposes to not adjust ODI rewards and penalties for taxation comparison with the cap of ±2% notional regulated equity.

1.4.2 BW Comment

We agree that Ofwat's proposed approach provides consistency with its proposed approach to tax, which we disagree with above. As such we consider this approach to be inappropriate, and consider that option 2 is more consistent with the approach we have proposed for taxation on ODI rewards and penalties. As Ofwat notes in the consultation, where tax allowances are not made in ODI rewards and penalties, this option is preferable to ensure consistency of tax treatment across different elements of ODIs.

1.5 Scheme ODIs

1.5.1 Ofwat Proposed Approach

Ofwat proposes to set out principles that will apply to the assessment of major scheme ODIs in PR19.

1.5.2 BW Comment

In general, we agree that Ofwat setting out principles is the most appropriate approach, along with companies providing progress reports to CCGs and a review by Ofwat at PR19.

The aim for this area should be to remove any ambiguity at the end of the period as to whether the scheme or the intended benefits have been delivered. We agree that it is most appropriate for companies to interact with CCGs to provide progress on delivery, with support from independent assurers. Ofwat could use the judgement of CCGs and independent assurers as the basis for a risk-based review at PR19 of which schemes may be more difficult to assess whether they have been delivered, and focus its own review in those areas.

We intend to publish six-monthly updates on performance against all our ODIs to be available to all of our customers, which will include progress against Scheme ODIs.

1.6 Asset Health ODIs

1.6.1 Ofwat Proposed Approach

Ofwat proposes to require companies to publish further details for asset health measures where these are not included in PR14 final determinations.

1.6.2 BW Comment

We agree that it would be helpful for all parties for the basis of assessment of asset health ODIs to be made clear. Interim assessments can be made available to CCGs, independent assurers and Ofwat during the period, ahead of the final submission to Ofwat at PR19.

2 Wholesale Totex

2.1 Definition of totex for menu sharing

2.1.1 Ofwat Proposed Approach

Ofwat proposes to exclude items not included in the menu baseline such as third party costs, pension deficit recovery and other disallowable costs. 2014/15 Transition costs are to be included and adjustments made for opex recharges.

2.1.2 BW Comment

We agree with the adjustments to reported actual totex proposed and we agree that a published definition of the costs to be included in the totex allowance is useful.

On the spreadsheet transition costs are requested to be input across AMP6 at outturn prices. As these are incurred in 2014/15, it would be preferable to input these costs in the 2014/15 column, at outturn prices.

2.2 Indexation

2.2.1 Ofwat Proposed Approach

Ofwat proposes to deflate future year total expenditure using actual RPI for comparison with the PR14 allowance.

2.2.2 BW Comment

We agree that this proposed approach is appropriate and consistent with the Final Determination and our expectation. For the avoidance of doubt, we consider that year average RPI should be used for this adjustment.

2.3 Allocation of totex out and under performance to revenue and RCV

2.3.1 Ofwat Proposed Approach

Ofwat proposes to allocate out- and underperformance using the weighted average PR14 PAYG rate, with companies providing robust evidence for changes that are in customers' interests.

2.3.2 BW Comment

We support Ofwat's approach as a default position, however, we consider that more flexibility is appropriate. Totex outperformance/underperformance may reflect a different outcome in terms of the balance between operating and capital expenditure. We believe that there should be an option to make RCV reflect actual capital expenditure, which would ensure the correct allocation of costs to be borne between current and future customers.

2.4 Time value of money

2.4.1 Ofwat Proposed Approach

2.4.2 Ofwat proposes to adjust all totex out and under performance for time value of money. BW Comment

We agree that this approach is appropriate as it will properly reflect the impact of when out-/underperformance occurred within the AMP. The rulebook should be specific as to which cost of capital will be used in this calculation, pre-tax, vanilla or post-tax and why that choice is appropriate.

2.5 Taxation

2.5.1 Ofwat Proposed Approach

Ofwat proposes to include a taxation adjustment for the customer share of the RCV element of totex out/under performance in PR19 only.

2.5.2 BW Comment

We disagree with an adjustment for tax on the RCV element, and consider option 3 to be distortive.

We consider that option 2 is more appropriate, whereby a tax adjustment is not made for the customer share of totex out-/under-performance in PR19. We believe this approach is more appropriate because if RCV is adjusted to take account of capital expenditure then no adjustment for taxation will be required. Therefore the argument against option 2 set out in the consultation, that the main drawback is the potential complexity of netting out the tax for the RCV adjustment, can be overcome because the impact of the tax allowance would be de minimus.

3 Wholesale Revenue Forecasting Incentive Mechanism (WRFIM)

3.1 In period ODIs

3.1.1 Ofwat Proposed Approach

Ofwat proposes to include revenue changes from in-period ODIs from the WRFIM reconciliation.

3.1.2 BW Comment

We agree that as the use of in-period ODIs is intended to produce adjustments to allowed revenues during the price control, it is appropriate that the revenue forecasting incentive takes account of those adjustments.

3.2 Taxation

3.2.1 Ofwat Proposed Approach

Ofwat proposes to not include a taxation adjustment on the revenue changes that result from the WRFIM at PR19, to ensure that companies do not receive a double allowance for taxation.

3.2.2 BW Comment

We agree with Ofwat’s proposed approach.

3.3 Blind Year

3.3.1 Ofwat Proposed Approach

Ofwat proposes to include a blind year adjustment in PR19 to account for 2019/20 revenue, rather than make an adjustment at PR24. This adjustment will be based on companies' forecast revenues for the blind year.

3.3.2 BW Comment

We agree that the proposed approach is appropriate.

4 Water Trading Incentives

4.1 Export incentive

4.1.1 Ofwat Proposed Approach

Ofwat proposes payment at PR19 of 50% of the full discounted economic profit for the forecast life of the export, capped at 100% of the economic profit for the years the export operates in 2015-20.

4.1.2 BW Comment

We agree that delay of the incentive payment until the end of the export is inappropriate as it would reduce the incentive for exporters.

We agree with the incentive being 50% of the full discounted lifetime economic profit.

5 PR09 reconciliation

5.1 Indexation in the CIS RCV

5.1.1 Ofwat Proposed Approach

Ofwat proposes to adjust the PR19 opening RCV for the amount remaining in the RCV due to the use of different indexation assumptions. This would result in a reduction in the overall industry RCV from 2020.

5.1.2 BW Comment

Our understanding is that the CIS end of period adjustment consists of two parts:

1. An RCV adjustment that reflects the difference in capital expenditure between that actually spent and that funded in the determination; and
2. A revenue adjustment to correct for any time value of money benefits from the actual timing of capital expenditure.

In order to calculate the difference between actual and determination expenditure (part 1 above), it is necessary to adjust both into the correct price base. To convert to a 2007/08 price base, the following steps have to be taken:

- Adjust actual capital expenditure to 2007/08 prices using outturn RPI; and
- Adjust FD09 input capital expenditure (which is in 2007/08 prices) to outturn prices using COPI, and then deflate by RPI back to 2007/08 prices.

The issue that appears to have arisen in the Final Determination is in respect of the second of these adjustments and relates to the appropriate COPI and RPI indices to use. The key issue is whether the indexation used for this step should be that forecast in FD09, outturn, or a mix as used in FD14.

In the Final Determination, Ofwat used the FD09 forecast for COPI to inflate costs and then used outturn RPI to deflate the costs back to 2007/08 prices. There are two alternatives that Ofwat could have used instead:

- Adjust the FD09 input capital expenditure by FD COPI and deflate by FD RPI (the approach that Ofwat now considers is correct); or
- Adjust the FD09 input capital expenditure by outturn COPI and deflate by outturn RPI.

In table A4.2 Ofwat sets out potential indexation options for the CIS. However, we consider that the latter of these potential approaches has been missed from this table. The table below includes this additional option.

Table 1 Potential indexation assumptions for the CIS - Allowed expenditure with additional option

Purpose		Alternative approach	FD Ofwat approach	Severn Trent approach	Additional option
RCV adjustment	COPI assumption	PR09 FD	PR09 FD	PR09 FD	Outturn
	RPI assumption	PR09 FD	Outturn	Outturn	Outturn
Financing costs adjustment	COPI assumption	PR09 FD	PR09 FD	PR09 FD	Outturn
	RPI assumption	PR09 FD	PR09 FD	Outturn	Outturn

Source: Ofwat consultation table A4.2

The correct approach depends upon the risk allocation for AMP5 that was intended by the mechanism:

(i) Under the approach in FD09, allowance capex (adjusted by FD forecast COPI) is compared to actual capex. The difference is deflated by outturn RPI. The exposure of the adjustment is to **Capex** and **RPI**.

(ii) Under Ofwat's new proposed approach, allowance capex (adjusted by FD forecast COPI) is deflated by FD RPI, and compared with actual nominal capex deflated by actual RPI. In this case the exposure of the adjustment is to **CAPEX** and **RPE**.[1]

(iii) Under the alternative approach, allowance capex (adjusted by outturn COPI) is compared to actual capex and the difference deflated by outturn RPI. In this approach the exposure of the adjustment is to **Capex**.

Our understanding is that the regulatory regime does not intend to expose companies to RPI risk. Therefore the first of these approaches, that was included in the FD, appears to be incorrect. Effectively, it rewards or penalises companies for inflation being different to forecast.

If the intention was that the adjustment was to be exposed only to capex differences then the third approach is the most appropriate. This approach results in the capital expenditure companies incur being compared to FD09 capital expenditure adjusted by actual COPI. As such it might be seen as a fairer comparison of actual expenditure to FD than the approach used in FD14.

An assessment of the benefit to customers should not consider the outturn adjustment of each option, but the risks taken by customers. Depending upon how inflation differs from the forecast in the FD, each approach potentially leads to gains or losses for customers. It is not correct to say one approach is better than another because the outcome is more favourable to customers. The correct assessment should be on whether the risk allocation is in customers' interest in advance.

At present, we are not clear what risk allocation was intended by Ofwat at PR09. The assessment of the best approach should start from this risk allocation. Consequently, we consider that Ofwat needs to provide a deeper and more thorough analysis of this issue before concluding on the correct approach.

5.2 COPI

5.2.1 Ofwat Proposed Approach

Ofwat proposes to adjust for COPI when accurate data becomes available.

5.2.2 BW Comment

We agree that this approach is appropriate.

5.3 Blind Year

5.3.1 Ofwat Proposed Approach

Ofwat proposes to include a materiality threshold for the blind year adjustment.

[1] RPE is the difference between RPI and COPI and represents the real price effect for capital expenditure. The exposure to RPE referred to here is that the outturn RPE is different to that forecast by Ofwat in its determination.

5.3.2 BW Comment

We do not consider that a materiality threshold is required. This position is supported by the results of Ofwat's own analysis which shows overall more greens for option 1, including for customer benefits and consistency with other reconciliation tools. As such, we believe that Option 1 is more appropriate, to adjust each of the mechanisms in full at PR19, with no threshold for materiality.

6 Household retail

6.1 Reconciliation

6.1.1 Ofwat Proposed Approach

Ofwat proposes to include a wash-up between allowed and outturn revenues in PR19, based on a forecast of revenues in the blind years. This includes a reconciliation of assumed and actual numbers of customers.

6.1.2 BW Comment

We agree that it is more appropriate to reconcile revenues than just focus on numbers of customers, as this will incorporate any variations in demand where companies have a variable retail tariff. Given that the materiality of the correction is expected to be relatively low we consider it is better to make this adjustment in full at PR19, rather than to delay the impact of the final year to PR24.

6.2 Time Value of Money

6.2.1 Ofwat Proposed Approach

Ofwat proposes to not adjust for the time value of money to account for when revenue was under or over recovered unless the differences are material.

6.2.2 BW Comment

We consider it is more appropriate to apply an economically sound method to this adjustment, even where the net impact is relatively minor. As such, we do not agree that no adjustment is made for the time value of money. It is important that this precedent is established to future-proof against such time as the relevant adjustment may be material. We consider that our proposed approach is in customers' interests as it would correctly account for the timing of any revenue over-recovery by the company.

6.3 Taxation

6.3.1 Ofwat Proposed Approach

Ofwat proposes to not adjust for taxation in its reconciliation of household retail revenues.

6.3.2 BW Comment

We agree that it is not appropriate to include an adjustment for taxation that would provide companies with a double allowance.

7 Other

Throughout the rule book it should be stated that:

- Final determination references should be adjusted to take account of Interim Determinations of K (IDoKs), CMA final determinations, and any other relevant changes.
- RPI is financial year average RPI (calculated from the average of the published RPI indices for each month in the financial year) unless otherwise specified.