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6th May 2015

By e-mail: PR14reconciliation@ofwat.gsi.gov.uk

Dear Tim,

Consultation on the PR14 reconciliation rulebook

On 25th March Ofwat published a consultation on the approach to the reconciliations required at the end of the 2015-20 price control together with a reconciliation rulebook (RRB) and a series of models that are proposed to be used to calculate the adjustments. This letter is our response to the proposals and contains some initial observations arising from our preliminary review of the RRB and the illustrative spreadsheets. We will write further if there are any issues arising as our understanding develops.

We welcome the transparency that is introduced by sharing the process, methodology and models so early in the period as this will certainly ensure that we can concentrate on strategic and material issues during the PR19 process. The “Legacy” issues are, in themselves, a material consideration at any price review but one that can largely be dealt with as an on-going exercise as actual data is collected at the end of each year. For this reason we believe that the Rulebook should remain ‘live’, such that the document can be modified over the AMP as issues arise and are resolved. This would allow the rulebook to remain contemporary and be flexible to changing circumstances.

The format of the response follows the layout of the consultation by taking each appendix in turn. However as a general point we believe that tax should be handled on a company specific basis, allowing a Company to choose or propose the appropriate tax treatment on a case by case basis. This would ensure that customers of companies for which reconciliation of tax is not an issue would not be affected by a generic approach. We would also note that the actual tax treatment does not follow the regulatory tax treatment so if a generic tax approach was taken the appropriate discount rate would need to be on a pre-tax basis.

Finally, for clarity, we note that Ofwat is not proposing a reconciliation for the non-household retail control and we agree with this.

Assessment framework (Appendix 1)

The proposed framework seems a sensible guide to assessing options.

Outcomes (Appendix 2)

There are a number of key issues that have been identified. We comment on two, treatment of inflation and aggregate ODI cap and collar:

Treatment of inflation

We have made commitments to undertake in-period assessments of ODI's and propose to make any adjustments arising with regard to the RPI change from November to November to ensure alignment with the charges setting process. We therefore support Ofwat's proposed approach to the indexation of in-period ODIs; and

Aggregate ODI cap and collar

We agree that as the outcomes framework is subject to a degree of uncertainty a safeguard, in the form of limits on the financial impacts, is a welcome suggestion. It is useful that the cap/collar has been explicitly stated in the spreadsheet. We also welcome the flexibility provided by allowing the cap or collar to be amended under certain circumstances and we will be working with our CCG to ensure that the arrangement does not work against the long term interests of our customers. One final point is to note that we have ODI's which operate net of compensation already paid to customers (and others) yet it is not clear how this will be handled in the spreadsheet.

Wholesale totex (Appendix 3)

There are a number of key issues identified in the consultation. We comment on two, definition of totex for the purposes of sharing and allocation of totex between RCV and revenue:

Definition of totex for the purposes of menu sharing

We agree that there is a need to split actual totex between that which is subject to cost sharing incentives and that which is not and the adjustments outlined in the consultation seem to be appropriate. However this is an area which we believe should be subject to further confirmation later in the period once the new accounting guidelines have been embedded and stakeholders have had more time to understand and review the Totex Menu Reconciliation model. We suggest that this would be a good area for a user group to be formed to ensure that the rulebook and model are joined up and robust. We would welcome the opportunity to be a member of any such group;

Allocation of totex out/under performance to RCV and revenue

We agree with the chosen option. It is crucial that there is flexibility for the allocation of the adjustment between RCV and revenue.

Wholesale Revenue Forecasting Incentive Mechanism (WRFIM) (Appendix 3)

Overall we welcome the introduction of the Wholesale Revenue Forecasting Incentive Mechanism (WRFIM) to incentivise companies to accurately forecast revenue through the application of penalty deadbands; it is important that this is not applied mechanically and companies have the opportunity to provide compelling evidence on any differences in the forecasted and actual revenue.

Treatment in WRFIM of revenue from in period ODIs

We have proposed a number of ODI's with in-period penalties and support the proposal (option 1) to include in-period ODI penalties in the allowed revenues in the WRFIM calculations. This principle can be extended for a number of other cases, for example: support for social tariffs which are part-funded by companies in the form of voluntary revenue abatements and in-period adjustments for the RCM true-up of the PR09 blind year (2014/15), which could also be supported by the same reasoning that has led to the proposal for option 1.

Treatment of blind year (2019/20)

We support the proposal to make an adjustment in PR19 for the blind year based on forecast outturns.

Water trading incentives

We support option 2b.

WRFIM model:

It would appear that the WRFIM model still needs fine tuning. In particular the input section is very light. The revenues that fall within the incentive mechanism have not been defined consistently, Table W9 and S9 and A19 provide some clues, as do the tables within the FD. However, the nomenclature of RAG3.08 is different and it is not clear what revenue falls into "revenue governed by price control", "revenue non-price control" and "other appointed revenue". It would avoid confusion and inconsistency if the inputs to this model and the revenue analysis in table 2I were aligned and explicit.

It also appears that the mechanism for rolling forward out/underperformance has a compounding effect of imposing penalties upon penalties which, we assume, is unintentional.

This is another area that would benefit from a modelling user group being formed to ensure that the rulebook and model are joined up and robust. We would welcome the opportunity to be a member of any such group

Reconciliation of PR09 incentives (Appendix 4)

We welcome the intention to close out the PR09 legacy issues as soon as possible rather than wait until the conclusion of PR19. The certainty created will benefit Ofwat, the companies and, most importantly our customers.

We are very concerned about the proposed change in policy at Ofwat to move to a materiality based methodology to assess the legacy true-ups. The incentive mechanisms were implemented and executed on a full recovery basis. Forecasts for year 5 were made on the understanding that under or over recovery would be reconciled by a full legacy adjustment. It would be disingenuous if Ofwat were to use a different methodology for the final reconciliation. We urge you to reconsider the precedent that would be set by this proposal to treat the same incentives differently at subsequent price reviews.

In a similar vein, the proposal to delay the COPI updates for the CIS model until the 'firm' data is published in 2016 (option1) can be the only consistent way to proceed.

The application of a materiality threshold will create inconsistencies in the treatment of true-ups between years 1 to 4 and year 5. This methodology could create preserve incentives to forecasting year 5 actuals in future price reviews. Finally the application of a materiality threshold is not in customer benefits, as highlighted within the rulebook as any outperformance in 2014-15 would not be passed on the customer.

In short, materiality thresholds have an important role to play in areas such as IDOKs, where they ensure that regulatory processes involving significant amounts of work for companies and regulators are not invoked to minimal ultimate effect. But the situation in respect of legacy adjustments is different: the process has already been applied, the work has been done, so a decision not to make the resulting arithmetical adjustment at PR19 is just arbitrary and potentially unfair.

We have also considered your preferred approach for the CIS RCV adjustment. The use of the CIS true-up model has not resulted in any detriment to our customers over this period. We were aware of the issue before we submitted the Business Plan in December 2013 which was submitted using our own calculated figure. It was discussed with senior management at Ofwat following the risk based review and we were instructed to use Ofwat's model rather than our own. After we had used the outputs from the Ofwat model the PAYG rate was adjusted in order to maintain the bill profile that we had proposed in the Business Plan and agreed with the CCG this meant that there was no resulting impact on customers. It is generally accepted that the Final Determination is a balanced package across all four price controls. The determination is arrived at in a way that incorporates elements that could be seen to be in our favour and elements that are challenging however this leads to a package that provides a good deal for both our customers and the company "in the round." Reopening the Final Determination for this single issue undermines this concept. We believe that option 1 "Do nothing" is the more appropriate as this is consistent with the methodology underpinning all Periodic Reviews.

Household retail (Appendix 5)

It is not clear why a true-up mechanism is required for the Retail household control. The incentive is inherent in the average cost benchmarking method of arriving at the revenue control and deviation within the period is addressed by the modification factors. The only material impact on the control will be the small proportion of incremental customers. We believe that, providing the governance and assurance remains robust, there is no need for a Household retail "wash up."

Supporting spreadsheets

We have included comments within our response to each specific appendix above from our initial review of the draft Rulebook and the supporting spreadsheets. We are continuing to review the models that you have published and will communicate any further issues we uncover in a timely manner.

If there is anything that we have brought up here that you wish to discuss please do not hesitate to contact me.

Kind regards

pp Mike Davis

Director of Strategy & Regulation