Northumbrian Water response to the Ofwat consultation on the PR14 reconciliation rulebook (May 2015)

Overview

Northumbrian Water welcomes the opportunity to comment on the proposals for the PR14 reconciliation rulebook. In particular, we appreciate the detail provided in the proposals, the draft models and the clear definitions of the data required.

It is very helpful to have these discussions at an early stage as this ensures we have many methodological issues clarified at the start of the 2015-20 period, allowing us to track our progress and any implications for customer bills in PR19.

We have covered our response to the consultation in this section, but have also included an important appendix on the draft models.

Summary

In general, the Ofwat proposals are well reasoned, with an emphasis on a balance between preserving incentives and transparency and consistency. We have only noted one area of disagreement, where we feel there is a solution to an issue that Ofwat have ruled out on complexity.

We agree that all proposals should be appraised as to whether they are in customers' interests.

Over time, incentive based regulation has proved itself to be in the interests of customers in providing higher levels of service alongside increased efficiency. In this response, all references to the preservation of incentives should be seen in the light of the benefits to customers.

Similarly, regulatory transparency and consistency are also in the interests of customers. As Ofwat state, by providing clear reconciliation rules, Ofwat avoids the situation where companies fail to act in the interests of customers because they make incorrect assumptions about the way that PR14 reconciliations will be carried out. In this response, all references to transparency and consistency should be viewed with this customer benefit in mind.

1 Outcome Delivery Incentives

1.1 The treatment of inflation

Ofwat proposal: Use actual average year RPI to inflate PR14 values to PR19.

NWL response: We agree with this proposal. The business plan and final determination were in average 12/13 prices and the PR19 financial data will be in average 17/18 prices.

Although NWL has no in period ODIs, we support the use of November to November RPI for these, as this is in line with the K factor approach that Ofwat are using, it is clear and minimises complexity.

1.2 The time value of money

Ofwat proposal: Option 1 - Do not adjust for the time value of money.

NWL response: We disagree with this proposal. Table A2.2 of the consultation shows two amber scores for this Option, under perverse incentives and consistency, whereas Option 2 is green, with one red score for complexity. We feel that the complexity issue can be dealt with by placing the onus on the companies to explain how the timing of the ODI penalties and rewards would be assessed.

The proposed approach would create a difference between the treatment of in period incentives, which would have the time value of money included and end of period incentives, which would not. It could also, as Ofwat note, create a perverse incentive for companies to delay delivery of ODIs where an additional investment was required.

There is also an important customer issue in the situation where penalties are payable. In period incentives will reimburse customers a value that includes the time value of money, whereas the proposal means that end of period penalties will not include a time value reimbursement.

Ofwat suggest that all companies had the option of a licence amendment so they could crystallise ODI performance earlier. This difference of approach was not transparent at the time these decisions were made, and we do not feel that creating an inadvertent incentive for in period over end of period ODIs would be in the interests of customers. We note that Ofwat's proposal for tax treatment emphasises the importance of avoiding inconsistencies between the treatment of in period and end of period incentives.

The second reason seems to be due to the lack of clarity on the timing of calculations. Whilst we understand that some ODIs like asset health have unclear calculations for some companies, Ofwat's proposals that companies publish further information on the operation of these indices should include explaining the timing of rewards and penalties. Indeed, we feel that companies should provide transparency for customers on the timing of all ODI rewards and penalties.

Finally, there appears to be some concern over the difference between the ODIs that affect the RCV and those that affect revenue. Provided both adjustments are made using the time value of money so they are equivalent, as per the proposed totex incentive model, we do not feel this should be an impediment.

In conclusion, whilst we understand that this initially may appear complex, there is an important principle of equivalence between in period and end of period ODIs that should be maintained. NWL would be very happy to provide an example of how the time value of our end of period ODIs could be calculated if that would help.

1.3 Taxation

Ofwat proposal: Option 2 – Allow taxation on ODI rewards and penalties as part of the PR19 review.

NWL response: We agree with this proposal. This is the most straightforward and consistent way of allowing taxation on ODI rewards and penalties. It matches the Ofwat calculation of taxation against the taxation that will actually apply, and it ensures that in period and end of period ODIs are treated in the same way. In our view, any links to willingness to pay are not materially undermined.

1.4 Aggregate ODI Cap and Collar

Ofwat proposal: Option 1 - Do not adjust ODI rewards and penalties for taxation comparison with cap.

NWL response: We agree with this proposal. As Ofwat note, to be consistent with the previous taxation policy on ODIs, this approach is correct.

1.5 Scheme ODIs (Whitburn & CIB for NWL)

Ofwat proposal: Option 2 - Ofwat set principles that will apply to the assessment of major schemes, the company is to report performance in period and Ofwat to review delivery at PR19.

NWL response: We agree with the proposal. Option 2 minimises regulatory intervention and it maintains company ownership of the scheme and responsibility for reporting on delivery. It also allows for innovation or even non-delivery where appropriate and justified. We agree that that companies should be primarily responsible for demonstrating the effective delivery of the schemes.

1.6 Asset Health ODIs

Ofwat proposal: Option 2 – Ofwat require companies to publish further details for asset health measures where these are not included in PR14 final determinations.

NWL response: We support the Ofwat proposal on transparency and comparative grounds, as stakeholders will wish to compare asset health performance across companies. We note Northumbrian is not in the initial list of companies with unclear calculations in the final determination. We are certainly committed to transparency over these measures.

1.7 Consistency of comparable ODIs

Although not specifically consulted on, we do support the expectation of transparency over the measurement and performance of all ODIs. Ofwat will be aware that Northumbrian is keen for there to be consistent definitions of data and calculations for all comparative ODIs across the industry, to allow customers to make valid comparisons. We look forward to continued dialogue over how this might be delivered.

2 Wholesale totex

2.1 Definition of totex for menu sharing

Ofwat proposal: Adjustments to reported totex will be required to ensure it is in the same terms as the final determination menu baseline. Thus, third party costs and pension deficit recovery costs will be excluded.

NWL response: The proposal is correct as far as it goes. There are important areas to check – these excluded costs need to be re-included after the cost sharing analysis as they are still valid totex when calculating the RCV adjustment for example.
Also, the Ofwat FD does make reference to wholesale market opening costs, which should also be excluded in the same way.

2.2 Treatment of Inflation

Ofwat proposal: Deflate future year total expenditure using actual RPI for comparison for PR14 allowance.

NWL response: We agree with this proposal. There is no FD or Actual COPI indexation, so the simple application of annual average RPI is sufficient to get the FD and Actual totex in the same price base. By keeping this in 12/13 prices, there is no need to forecast RPI to 17/18. The results will need indexation to 17/18 prices in PR19, but this can be done when the index for 17/18 is known.

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

Ofwat proposal: Option 3 - Use weighted average PAYG rates to allocate the customer share of totex out/under performance between revenue and RCV.

NWL response: We agree with this proposal. Using weighted average PAYG rates is a reasonable, simple approach. We also agree it would contradict the PR14 totex approach for the customer adjustments to be done as entirely revenue or RCV adjustments.

To be clear, we interpret this Option as per this example:

A £100m underspend would be allocated between company and customer at the menu incentive rate, say 50:50.

Of the £50m customer part, this would be split on the weighted average PAYG rate between revenue and RCV, say 60:40.

This would mean a £20m adjustment to the shadow RCV.

It would be helpful if the implications of this option could be made clear in the calculations for the shadow RCV in the annual reporting guidance.

2.4 Treatment of time value on totex sharing

Ofwat proposal: Option 2 - Adjust all totex out and under performance for the time value of money.

NWL response: We agree with this proposal. It is consistent with the previous approach to capex in the CIS model and it does recognise the time value of totex variations. It avoids perverse incentives and it does ensure the incentive rate includes the effect of in period cash flows.
Our only proviso is that, to be consistent with this, the time value of ODIs should also be recognised.

2.5 Treatment of taxation on totex sharing

Ofwat proposal: Option 3 - Only including a tax adjustment for the customer share of the RCV element of totex out or under performance in PR19 is the most appropriate approach.

NWL response: We agree with this proposal as we understand it, although we would welcome some clarification on it, an example would help.
We interpret a 'tax adjustment' as meaning that the cash flows as a consequence of the customer share of totex outperformance would be treated as taxable in the PR19 financial model and thus have an impact on the taxation allowed in price limits in the model.
We read Option 3 as Ofwat suggesting that, in the PR19 financial model, the return on the RCV would be treated as fully taxable, but the customer share revenue adjustment due to totex out or under performance would not be (ie tax funded in price limits would be unaffected).

Example:
We have assumed an underspend, but the logic and calculations are symmetric for an overspend.

A £100m underspend would be allocated between company and customer at the menu incentive rate, say 50:50.

Of the £50m customer part, this would be split on the weighted average PAYG rate between revenue and RCV, say 60:40. We will assume for this example that this matches the opex: capex ratio for taxation purposes.

The £30m revenue part would be passed on to customers at PR19, with no adjustment for the lower taxation charge on the company that this would imply. This is correct, as the underspend itself would have generated higher taxation during 2015-20 which would be borne by the company.

The RCV part would generate lower returns, which would reduce taxation, captured in price limits. However, this will be offset by the lower capital allowances pool on the lower capex in the period, resulting in higher customer taxation, to be included in price limits.

It is this impact of capital allowances that rebalances the RCV element in Option 3, such that the overall impact of higher taxation on outperformance is spread broadly equally between company and customer, in line with the incentive rate.

We can provide a spreadsheet that illustrates this point in a simple way if required.

3 Wholesale WRIFM

3.1 WRIFM and In-period ODIs

Ofwat proposal: Option 2 - Include in-period ODI rewards and penalties in the allowed revenues in the WRIFM calculations.

NWL response: Although not strictly relevant for NWL, we agree with this proposal. Non inclusion would mean that in-period rewards and penalties would be reversed by the WRIFM, making them valueless.

3.2 WRIFM and Taxation

Ofwat proposal: Option 2 - Do not include a tax adjustment on the revenue changes that result from WRIFM in PR19.

NWL response: We agree with this proposal. If revenue falls short of the FD, then the WRIFM rises and the tax paid by the company reduces. At the next review, if

Ofwat do not allow the tax on the WRIFM to be funded, the company pays tax on this and is back in the same position – the aim of the WRIFM.
Symmetrically, if revenue is higher than FD, more tax is paid by the company, the WRIFM becomes negative, but this reduction is ignored when setting tax allowances in PR19, allowing the company to recover the tax.

3.3 Treatment of the blind year (2019-20)

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

NWL response: We agree with this proposal. This is in line with the previous RCM approach. We agree that this would also reduce the scale of any PR24 adjustment and maintain a direct link between company performance and bills.

4 Water Trading Incentives

Ofwat proposal: Option 2b - For exporters – Ofwat propose an incentive worth 50% of the full discounted lifetime economic profit, with a cap of 100% of the economic profit for 2015-20.

NWL response: We agree with this proposal.

This is important for NWL as we propose to apply for an incentive for our recently agreed water trading agreement with Thames.

We feel, in the spirit of transparency and early understanding of our company position, that discussions over our bulk supply incentive could be agreed much earlier than during what will be a demanding PR19 process.

We also agree that the incentive calculation should be adjusted for inflation and the time value of money, as well as a tax adjustment in PR19.

5 PR09 Reconciliation

5.1 Indexation in the PR09 CIS RCV adjustment

Ofwat proposal: Adjust the RCV in PR19 to remove the amount remaining in the RCV from the use of different indexation assumptions.

NWL response: As Ofwat state, there are three indexation options that could potentially be consistent with the original policy intent set out in the PR09 documentation. In our view, Ofwat’s proposal of Option 2 creates regulatory uncertainty which undermines trust and confidence in the regulatory regime. The Final Determination suggested there “<u>may</u> be a <u>slightly</u> different 2015 opening RCV”, which does not convey the scale of the proposed adjustment and appears to suggest that there is some ambiguity as to the technically correct approach. As such we favour Option 1, as this reflects the terms that companies relied upon when accepting the Final Determination.

If Ofwat decide to follow Option 2, then the following should apply:

No amendment should be made to the PR14 Final Determination.
No amendment to the shadow RCV – any adjustment would be a PR19 midnight adjustment.
Any amendment should be made after deducting the run off rate adjustment over 2015-20.

5.2 Blind year reconciliation (14/15) : use of materiality thresholds

Ofwat proposal: Option 2 – apply a materiality threshold in aggregate to revenue and RCV adjustments.

NWL response: We agree with this proposal. We presume this calculation excludes the PR09 CIS RCV adjustment, which will be material for all companies.

5.3 COPI updates for the CIS model

Ofwat proposal: Option 1 – Adjust COPI in the CIS models when updated data becomes available.

NWL response: We agree with this proposal. As Ofwat state, the impact will be part of the PR19 true up, so there is no need for an immediate solution per Options 2 & 3.

6 Household Retail

*Ofwat proposals: Option 2 - To ‘wash up’ any differences between actual and forecast revenues (due to differences between customer numbers **and** the revenues per customer) at the end of the period. As this would include total revenues, it would include a reconciliation of customer numbers.*

NWL response: We agree with this proposal. This is the least intrusive and most practical option. Note that the main revenue variations should be due to customer numbers, which will be adjusted for, but there may be some smaller variations of revenue per customer.

We also agree that it is unlikely that any financing adjustment would be material and that there should be no tax adjustment on revenue changes from the PR19 household retail true up.

Appendix: PR14 Rulebook – Line by line analysis of models

1 The Outcome Delivery Incentive Reconciliation Model

General Inputs: Regulated Equity

The methodology confirms that the cap and collar limitation will apply to the wholesale water and wastewater controls separately. This can be handled if WaSCS are required to complete two separate ODI models, one for each service. We also assume that our retail delivery pc would be submitted on a third model.

Line 4 of the rulebook suggests Regulated Equity is taken from the nominal tabs of the financial model, with average net debt deducted from average RCV, and the result deflated by the forecast RPI in the financial model.

However, the Line 2 definition indicates year average RCV is in 12/13 prices, which contradicts the model annotation. We believe the definition should be changed to nominal.

Also, the model uses the line 'indexation average' from the RPI tab, which can be overwritten, which would making the deflation of regulated equity incorrect. We feel it would be safer to have this FD indexation fixed so it cannot be changed.

Finally, our calculations using the model give regulatory equity cap/collar of £85.5m and £71.912m for water and sewerage respectively. This differs slightly from the £82.46m and £69.392m figures for NWL in the 'Agg caps and collars' tab. As there is no formula behind the figures, we cannot see how they were derived.

ODI Inputs

We suggest that, for the final model, Ofwat add another 8 ODI tabs for each service. No company only has two ODIs for a service, and to rely on companies to manually add their own tabs and amend the aggregation calculations by adding multiple rows defeats the point of a standardised assured model.

Our only other observation is that Asset Health ODIs will have to be modelled as bespoke.

2 The Totex Menu Reconciliation Model

Inputs:

Line 5: Implied menu choice
This line is actually redundant – the data is not used in the model. The key data is actually input on line 8: Allowed totex. We suggest this line should be removed to avoid users believing they have made an adjustment to the model when they haven't.

Line 7: Baseline totex
For clarity, Ofwat should confirm this is the 'menu cost baseline' per the company specific FD. We presume it refers to lines C00007_W011 and C00008_S011 from the wholesale menu FD models. It thus excludes pension deficit recovery costs, 3rd party costs and market opening costs relating to 2014-15.

Line 8: Allowed totex
In the FD, there are two 'allowed totex' lines: 'Allowed expenditure from menu' and 'Total allowed expenditure'. The difference between the two is the addition of 'Costs excluded from menu' in the latter.

The wholesale menu FD models have outputs for 'allowed expenditure from menu' (C00009_W004 and C00010_S004). However, we believe that this line should actually include 'costs excluded from menu' and thus instead reflect 'total allowed expenditure'.

Our reasoning is that, on the calculation tab, line 102 compares Actual totex to Allowed totex. **The Actual totex figure used here is not the Menu amount – i.e. it includes the excluded costs.** So, to make a like for like comparison with Allowed totex, the Allowed totex must also include the excluded costs.

We can supply a simple version of the model to illustrate this if requested.

Calculations:

Line 4: Actual totex (rebased to 12/13 prices)
At present, this totex is rebased using FD RPI forecasts. It should be made clearer that this RPI will have to be overridden by actual RPI. Indeed, we suggest that the RPI tab be expanded so there is a separate line for Actual RPI Fin Year Average, and the model should use that line for this calculation.

3 The WRIFM Model

Since the original consultation on the WRFIM, the FD has clarified that there will be no in-period adjustments to allowed revenues. We welcome this clarification, however, it leaves a significant flaw in the WRFIM spreadsheet, meaning that revenue variances are incorrectly adjusted for more than once. This issue arises from the use of the two year lag in adjusting revenues, which is not strictly needed if there are no in-period adjustments. There are also several calculation errors in the WRIFM model that will need correction or clarification. We discuss each issue separately below.

Inputs: Allowed Revenue

The rulebook states that annual allowed revenues should be taken from the final determination. However, the final determination revenue controls comprise a revenue value for 2015-16, with K factors set for the following years.

We believe that the rulebook should clearly state that allowed revenue as set out in the financial model *(line 299 of the Water/Waste Real AR tabs – Final allowed revenue (deflated using Nov-Nov RPI))* should thus be the input to the WRIFM model, as it is this revenue that was used in setting the K factors.

Calculation Pages: WRIFM

Double and treble counting of revenue variance penalties

Line 30 – Over / (Under) recovery

The WRFIM was originally written assuming in-period revenue adjustments, but has not been updated fully for the fact these are now end of period adjustments.

This is illustrated by page 44 of the draft rulebook, which states, in the definition for Allowed Revenue (AR) "the allowed revenue from the charging years beginning 1 April 2017 <u>being adjusted by the RIFM for that year.</u>" This <u>contradicts</u> point 3 on page 45 which states "Allowed revenues, set by the RPI +/- K factor in the licences are <u>unaffected</u> by the WRIFM".

The current model means that it assumes the allowed revenue is adjusted with a two year lag, even though it will not be adjusted in practice. This means that from 2017/18 the WFRIM model calculates a revenue adjustment based on a variance that will not occur in reality.

Point 5 in the rulebook refers to a '**<u>notional'</u>** annual allowed revenue adjustment, but it is not clear whether this is the automatic model adjustment in line 24 of the

WRIFM, or whether it suggests that the allowed revenue entered on the *Input* tab for year t should be amended to reverse any variance generated in year t-2.

The definitions on page 50, line 7 for annual allowed revenue make no mention of a notional adjustment, but simply refer to the FD figures. The definition of AR in the formula also does not reference the relationship to a “notional” allowed revenue.

In our view, the only adjustments that appear over the five years should be the actual variance between the PR14 allowed revenue and the actual recovered revenue. This gives the penalty and the difference adjustment, but does not lead to double counting revenue variances and penalties.

Ideally, the WRFIM formula should be completely changed to remove the two year lag would be much clearer if it simply accumulated all 5 years of variances and penalties in the same way as the PR09 RCM. Alternatively, this could be more simply corrected by using the allowed revenue entered on the Input tab as the baseline revenues used to calculate a revenue variance.

Double counting of indexation of variances

Line 39 - RFIM adjustment - to be applied after two year lag

The indexation applied in the calculation is incorrect. The formula indexes the over/under recovery in line 20 by using the next two years figures taken from the RPI tab. However, this RPI data is a <u>cumulative</u> change in RPI inflation from 2012/13, rather than the annual RPI index as set out in the WFRIM formula definition. Thus, Ofwat are double counting inflation in this calculation.

Instead, Ofwat should use the index from two years ahead divided by the outturn index. This will inflate the figure by 2 years.

4 The Household Retail Model

Missing Inputs

Page 56-57 of the draft rulebook identifies inputs that are not in the Household Retail Model. These are:

Line 1: Forecast customer numbers
and
Line 4: Allowed revenue from household retail

We note that model does not seem to need these inputs, so we suggest they are removed from the rulebook.

Indeed, we note that the model performs a two stage calculation using reforecast customer numbers. However, when these are added together to reach the net adjustment (line 68), the reforecast numbers cancel out, leaving the net adjustment as simply:

Net adjustment = (Actual Customer numbers * Modification factor) - Actual revenue.

So, if all that is of interest to Ofwat is the net adjustment, the model could be simplified further by excluding the reforecast customer numbers inputs.

Inputs in the incorrect order

Also, Line 6 in the rulebook: Actual Revenue collected comes before Line 5: Modification Factors in the inputs page, so we suggest the order of these is reversed.

Unclear input unit of measurement for Reforecast and Actual customer numbers.

The rulebook and model do not identify the input unit of measurement for the customer numbers; whether it is in units, thousands or millions of customers. We note the FD does show forecast customer numbers in thousands.

The calculation page lines 20-25 indicates a value in £m. This is derived from multiplying the modification factor per the FD, a value in £, by customer numbers. <u>This means that customer numbers must be input as millions.</u>

The model and guidance should be amended to make this unit of measurement clear as all previous customer numbers published have been measured in thousands.