CONSULTATION ON PR14 RECONCILIATION RULEBOOK – SOUTH EAST WATER'S RESPONSE

MAY 2015

This paper sets out South East Water's (SEW) views in response to Ofwat's consultation on the PR14 reconciliation rulebook.

1.1 INTRODUCTION

We are pleased that Ofwat has sought to give precision and clarity to the mechanisms to be applied at PR19, where they relate to performance in the 2015-20 period.

Within this response we have dealt with all the elements of the rulebook but you will see that our biggest concern relates to the proposal to adjust the RCV at PR19 as a result of a change to the published CIS true up mechanism.

Our concerns in this area are centred on 5 fundamental issues:

1. Regulatory consistency and good regulatory practice
2. The uncertainty created by this proposal weakens the effectiveness of the CIS mechanism and all future incentive mechanisms which are set up to protect customers' interests.
3. The fact that this is a change to a previously published and challenged policy and not the correction of an error or oversight
4. The proposal only seeks to change one element of a complex package
5. The proposal ignores the fact that SEW demonstrably reacted to this incentive in both the investment strategy for the period 2010-15 but also in its business plan for the period 2015-20.

Within the previous price review period, as early as 2011, SEW was active in developing tools and seeking early clarification from Ofwat on the proposed 'PR09 true-up' methodologies. In particular we sought and obtained precision and clarity from Ofwat on the CIS mechanism via a series of meetings, follow up correspondence and the exchange of worked examples. We will demonstrate the extent of this communication and how SEW responded to the incentive based on these clarifications.

1.2 THE IMPORTANCE OF REGULATORY CERTAINTY

In the consultation document (p8) Ofwat states that '*PR14 determinations were made consistently with the principles of best regulatory practice under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only in cases where action is needed.*' These principles of good regulation are important and in particular we believe that proper emphasis should be put on the need for a stable and predictable regulatory framework.

The Government's '*Principles for Economic Regulation',* published in April 2011, set out guidance for best practice regulation by economic regulators. This document states that ‘The purpose of the Principles for Economic Regulation is: *to reaffirm the importance of, and the Government’s commitment to, stable and predictable regulatory frameworks to facilitate efficient investment and sustainable growth*.[1]

The proposals in the consultation to adjust the RCV at PR19 as a result of a change in indexation from what was the published and agreed methodology for PR14 is neither ‘*stable or predictable*’ in the government’s words, nor ‘*transparent or consistent*’.

We also consider that Ofwat is not putting sufficient emphasis on the long term interest for customers of a stable regulatory framework which favours long term investment. We would take the view that a stable regulatory framework where incentives are designed and followed through is very much in the customers’ long term interest. To make a change such as is proposed will inevitably weaken confidence in such incentives and deter investment which in the long term will not be in the interests of customers. Later in our response we provide an example from a 2012 Competition Commission determination where the following conclusion was reached in very similar circumstances:

> *‘we believe that it is in the public interest to take account of the incentives and rewards required for companies to make investments and take risks, as well as providing incentives for future network investment and expansion—thus meeting the needs of future customers.”* and;
>
> *“we think that the long-term public interest is best served by a stable environment that encourages confidence and investment.”*

We believe that the approach taken to the assessment of options is flawed in the consultation as it focuses on a narrow definition of customers’ interests and on their short term interests. It does not fully take into account the principles of best regulatory practice and the long term public interest that flows from a stable and predictable regulatory regime.

1.3 SETTING A PR19 RULEBOOK WHILST SEEKING TO MAKE A MATERIAL CHANGE TO AN INCENTIVE MECHANISM FOR AMP5

South East Water wholeheartedly supports Ofwat’s objectives in setting and clarifying the detailed workings of incentive mechanisms early in the regulatory period. This is something that the Company actively encouraged Ofwat to do post PR09.

It is therefore extremely disappointing, and somewhat ironic, that in the same document Ofwat is proposing to materially change an incentive mechanism on which they had given total clarity in the previous regulatory period. This proposal serves to question and undermine the very regulatory certainty the rulebook is trying to achieve.

[1] Principles for Economic Regulation April 2011. p.2. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31623/11-795-principles-for-economic-regulation.pdf

1.4 OFWAT'S PROPOSAL WOULD NOT "CORRECT" AN ERROR BUT REVERSE A CLEAR POLICY DECISION, MADE KNOWINGLY BY OFWAT

It is our view that in this case we are not dealing with an error that has just been discovered – this was a conscious policy decision arriving at a mechanism which was tested and challenged repeatedly by ourselves and other companies. We are aware that there are always a number of ways of approaching any methodology, however the same established mechanism applied throughout AMP5 and the price review process, allowing Board decisions on long term investment strategies early in the planning period through to the subsequent application of incentives at the price review.

To continue with the proposal as it stands will severely weaken the strength of future incentive arrangements that are put in place. This acts against the intention of such incentives. It deters investment and is detrimental to long decision making which will clearly not be in the long term interests of customers.

1.5 SEW ENGAGED EARLY, CHALLENGING OFWAT ON THE MECHANISM, AS UNDERSTANDING THE MECHANISM WAS IMPORTANT FOR BASING OUR INVESTMENT DECISIONS

During 2011 we initiated very early discussions with Ofwat as we needed to understand how the CIS mechanism would work and the implications for our capital programme. We sought and obtained precision and clarity from Ofwat on the CIS mechanism via a series of meetings, follow up correspondence and the exchange of worked examples, including challenging the proposed approach. Following such detailed engagement with Ofwat on the forward treatment of revenues and RCV within the CIS mechanism the Board felt comfortable to make informed investment decisions.

During the PR14 process SEW had lengthy discussions with Ofwat on the subject of serviceability shortfalling. We set out our case that there had been no clear mechanism established from the PR09 determination, however Ofwat disagreed. In these discussions Ofwat told us directly that if we had been in any doubt about the workings of the PR09 mechanisms we should have sought clarity from Ofwat. Regrettably, we find ourselves in just such a position with regard to the CIS mechanism. We received helpful clarification on the proposed CIS mechanism, with company specific worked examples. Investment decisions were made on this basis and we now find that it is proposed to alter this mechanism.

For us, 'regulatory certainty' is quite a clear concept – it should be that Ofwat can be relied upon not to do a U-turn. It is difficult to see how Ofwat's preferred approach on this issue is consistent with their objective of improved trust and confidence.

1.6 THE CHANGE THAT OFWAT IS PROPOSING IS SIMPLISTIC – THE RCV IS ONE ELEMENT OF A COMPLEX SET OF INTERELATED ISSUES

We do not agree that an “issue” needs to be “remedied”. Ofwat is proposing a one off and significant adjustment by just reducing the RCV. We believe that such a change should take a number of other factors into consideration for SEW. The numerous impacts of these factors are difficult to quantify as that would involve rerunning strategic Company decisions over the last 5 years. Nevertheless, the following illustrates that this is not a single issue problem:

1. Would SEW have invested differently had they known that the RCV would be adjusted as proposed? - yes probably and at a lower level with a different risk profile,

2. Would this have affected elements of the business plan bipartite discussions with Ofwat and the determination? – yes on the following:

a. SEW would have been more efficient on the models due to lower historic costs and potentially this carried significant benefits that were unrealised,

b. Would SEW have asked for a different level of future capex and therefore different adjustments? – potentially yes,

c. Would SEW have proposed a different PAYG rate? – potentially yes,

d. Would SEW have proposed a different run off rate? – potentially yes,

e. Would SEW used the position it found itself in to present a different case on the SCP? – potentially yes.

Given all this, just adjusting the RCV seems wholly inappropriate - the RCV is just one element of a complex set of interrelated and consequential issues going back 5 years and informing our Business Plan and our alterations following the Risk Based Review and discussions with Ofwat. It should also be noted that these issues are not confined to this period but relate to a longer term view of the business in terms of both risk and reward.

In consideration of the above we strongly oppose an adjustment to the RCV and dispute that Ofwat should consider this option considering that:

- it did not give any consideration to the extensive exchange it had with SEW and to its clear confirmation of how the CIS mechanism would work which was communicated to SEW in 2012 and confirmed thereafter;
- it failed to properly consider the retrospective effects of its proposal and the fact that it would necessarily alter the consequences of SEW investment decisions during AMP5 which were made in reliance on the considered and formal clarifications provided by Ofwat. The implementation of this proposal would be grossly unfair to SEW;

- The proposal to alter the effect of an incentive mechanism after the event is grossly unfair or even irrational in respect of an incentive which is designed to influence companies' behaviour based on the risks and rewards of that incentive; and
- it does not demonstrate that a countervailing public interest would justify its proposal and be such that it could compensate for the detriment to SEW and to regulatory certainty caused by a reversal of its decision.

2 OUTCOME DELIVERY INCENTIVES (ODI) MECHANISMS

SEW Summary

Item	*Ofwat Proposal*	*SEW View*
Indexation	Use actual average year RPI to inflate PR14 values to PR19	Agreed
Time value of money	Do not adjust for time value of money	Time value of money does exist, so in principle this is selective to exclude – but there may be practical constraints on determining the precise timing of rewards/penalties. However the principle of consistency should be followed.
Tax	Allow taxation on ODI rewards and penalties as part of PR19 review	Emphasise marginal tax rate of 20% should be used.
Aggregate cap and collar	Cap at +/-2% of regulated equity. Do not adjust ODI rewards and penalties for taxation comparison with cap to be consistent with above.	Agreed
Scheme ODIs	Sets out principles that will apply to the assessment of major scheme ODIs in PR19	SEW does not have any scheme specific ODIs.
Asset health ODIs	Require companies to publish further details for asset health measures where these are not included in PR14 final determinations	SEW has provided this detail in June BP submission and is reflected in FD document PC[N2].
Blind year	Forecasts are applied and corrected at PR24 as appropriate after assessing materiality.	Agreed
Rulebook		Indexation inconsistencies Confirm that proposed cap does not apply to retail.

2.1.1 COMMENTS ON OFWAT APPROACH

SEW has a set of seven customer satisfaction ODIs. The reward/penalty from these ODIs is split between wholesale and retail businesses by varying percentages. The rulebook methodology does distinguish between wholesale and retail businesses by using separate models for each. We are more familiar with how wholesale adjustments are made via the revenue cap or RCV, but we would like more detail on how the retail revenue adjustment will be made – will they be applied via the ACTS?

The proposed cap is aggregated and applied only to the wholesale elements. We would like to be absolutely clear that the retail component of the ODIs is excluded from the cap.

2.1.2 RULEBOOK COMMENTS

The ODI rulebook model issued has a list of ODI caps in the worksheet <AggCaps>. It gives a figure of £44.481m for SEW. However when the model inputs are populated for Av RCV and Av Net Debt from the published FD model the figure is calculated as £46.103m. This is as a result of different RPI assumptions in the two models. Ofwat should be clear as to whether it is the FD RPI assumption or the actual RPI which should drive the indexation. The rulebook states using 'the forecast RPI series from the financial model' but there are not inputs for such FD inflation as separate from the actual inflation. An alternative may be to have the cap as an input cell.

3 WHOLESALE WATER COSTS AND REVENUES.

3.1 TOTEX COST SHARING

SEW Summary

Item	*Ofwat Proposal*	*SEW View*
Definition of totex for menu sharing	Exclude items not included in the menu baseline such as third party costs, pension deficit recovery. Need to adjust for 'principle use' accounting of assets vs historic cost treatment currently in menu baseline.	The assumed level of 'historic cost' treatment of assets in the menu baseline is not explicit from Ofwat's derivation of the baseline.
Indexation	Deflate future year total expenditure using actual RPI for comparison for PR14 allowance.	Agreed
Time value of money	Adjust for time of money for customer sharing of out-/underperformance.	Agreed
Tax	Include a taxation adjustment for RCV changes only.	Agreed
Allocation of totex out and under performance to revenue and RCV	Allocate out- and underperformance using weighted average PR14 PAYG rate, with companies providing robust evidence for changes that are in customers' interests.	Agreed
Blind year	Forecast used.	Agreed
Rulebook	Model issued for two wholesale ODIs	Need to modify model to allow for all ODIs and to separate wholesale and retail ODIs.

3.1.1 COMMENTS ON OFWAT APPROACH

Definition of totex for the purposes of menu sharing.

Ofwat identifies a number of adjustments to actual spend which are considered necessary before the comparison of actual spend with the menu baseline.

It seems that the majority of these adjustment items will be identified, defined and collected via the RAGs and regulatory accounts. Sufficient detail of the adjustments should be provided in these definitions when they are revised (due April 2015).

In the list of adjustments which Ofwat indicate will need to be made is depreciation, whereby in setting the baseline Ofwat indicates that a historic cost approach was used, whereas actual expenditure and associated asset recharges will be on a principle use basis.

We would like Ofwat to be clear as to the assumptions applied on depreciation when setting our baseline. We cannot find this level of detail for the baseline set out in our final determination documentation.

3.2 WRFIM (REPLACES REVENUE CORRECTION MECHANISM)

SEW Summary

Item	*Ofwat Proposal*	*SEW View*
In period ODIs	Exclude revenue changes from in-period ODIs from WRFIM reconciliation. i.e allowed revenues adjusted for in period ODIs.	No in-period ODIs agreed for SEW so not at issue for current period. OK to principle.
Inflation	Nov-Nov indexation.	Agreed
Time value of money	Adjusted.	Agreed
Tax	Do not include taxation adjustment in PR19 as tax already allowed.	Agreed
Blind year	Include blind year adjustment in PR19 using forecast outturns.	Agreed

3.2.1 COMMENTS ON OFWAT APPROACH

We have commented previously on the proposed revenue incentive mechanism. As SEW is already a highly metered company and is aiming to have all properties metered, where practicable, by 2020. We have responded in previous consultations that this level of metering exposes us to higher variability in outturn recovered revenues than companies with lower levels of metering. We are disappointed that Ofwat has not identified this bias in the ‘specific areas that could give rise to variance above the revenue flexibility threshold.’ For a fully metered company it does not take much variation from normal climatic conditions to generate 2-3% variation in demand and therefore revenue. We are wary that imposing ‘excess’ revenue penalties without consideration for corresponding production costs, gives an unfair bias to this mechanism which is further exacerbated for highly metered companies.

We took the decision to be fully metered in many respects as a result of the influence of the government and regulators (Defra, EA and Ofwat), acknowledging the water scarcity within the south east of England and the need to reduce customer consumption. Our metering programme has been developed within a legislative framework which specifically contemplates the need for and allows for compulsory metering when certain conditions are satisfied. Our Water Resources Management Plan has been approved by Defra and has been developed under their and the Environment Agency's scrutiny. Having, to a large extent, implemented this we now find ourselves in the un-enviable position of greater risk of fluctuation of revenues. However this inevitable fluctuation is not being recognised adequately within the mechanisms proposed by Ofwat. The proposal for asymmetric incentives for revenues is not consistent with the original costings and decisions taken, acknowledging the objectives of the regulators, at the commencement of the metering programme. There is therefore inconsistency between different branches or agencies of Government as a programme which has been approved following a statutory process results in a less favourable treatment by another agency, namely Ofwat. We consider that this approach is contrary to the principle of "consistency" set out in the Principles of Good Regulations and to the principle of "coherence" of the Principles for Economic Regulation and that as such Ofwat should review its approach.

In the consultation Ofwat states that there will be a 'high evidential bar' for representations on the reasons for the variances that give rise to an incentive. We would like Ofwat to be more specific in the rulebook and to provide more information on what level of evidence would be acceptable, particularly surrounding what would be considered to be acceptable evidence for variation from 'normal' climatic conditions.

3.3 WATER TRADING

SEW Summary

Item	*Ofwat Proposal*	*SEW View*
Export incentive	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	Not relevant for SEW in PR14. Applying the proposed cap delays the receipt of the incentive payment, particularly where costs are incurred before income is received.
Import incentive	Benefit from an extra 5% of costs of water imported – subject to the annual total of these extra payments not exceeding a cap of 0.1% of the importers water activity turnover.	Not clear whether 'water activity turnover' refers to wholesale only or wholesale + retail turnover. We believe it should be total turnover.
Inflation	Applied to base year	Agreed
Time value of money	Adjusted	Agreed
Taxation	Allowed	Agreed

3.3.1 COMMENTS ON OFWAT APPROACH

SEW did not forecast any income in this area so this will not impact ourselves at PR19. However for future reviews water trading is likely to feature, at least as feasibility options, within our WRMP.

There is no mention of Water Trading incentives in the current version of the Rulebook, however we have reviewed the spreadsheet model issued.

<u>Export incentive</u>

We have some concerns with the treatment of the proposed cap in the mechanism – particularly relating to the delay in timing of the payment of the incentive. Where there are costs to be taken into account as part of the implementation of a trade the cap in the first period can be very low and therefore the incentive received in the first period is also very low in relation to the total incentive due. This is shown in the example spreadsheet model issued (summarised in the table below) where the incentive paid in the first period is only 10% of the total incentive to be paid.

	2015-16	2016-17	2017-18	2018-19	2019-20	
Forecast revenue from export 1	-	2.0	2.0	2.0	2.0	/….
Forecast cost (inclusive of return on capital) of export 1	3.0	1.0	1.0	1.0	1.0	/….
Net revenue/(cost) for export 1	(3.0)	1.0	1.0	1.0	1.0	/….
Incentive payment due: 50% of NPV of economic profit (profits above the normal return on capital) for export 1						**6.3**
Discounted net revenue/(cost) for cap for export 1	(3.0)	1.0	0.9	0.9	0.9	
Sum of discounted net revenue/(cost) for cap for export 1						0.7
Export incentive payment for export 1 to be paid at PR19						**0.7**
Balance of export incentive payment to be paid after PR19 for export 1						**5.7**

We believe that applying the cap within the methodology proposed unnecessarily increases the uncertainty of the incentive ever being recovered over future review periods. We believe that there is probably a further option which strikes a better balance between Option 2a and 2b, for example by allowing a higher fixed percentage of the total export incentive payment to be allowed in the first period.

Certainly if the proposed cap is to be retained we consider that the time value of money should be applied as the difference between incurring costs to execute a trade and recovering the incentive can potentially be a significant period of years.

<u>Import incentive</u>

The methodology states that the cap to be applied is 0.1% of the importers water activity turnover. It is not clear from the text or the model whether this refers to the wholesale business or the total turnover including retail activity. We believe that it should be applied to the turnover at the total water business level.

3.4 UNCERTAINTY MECHANISMS

On p59 of the Rulebook document the statement of the 'sharing rate' as *75%:25% customer:company* could be misinterpreted. The subsequent sentence becomes clearer in that *'The mechanism ensures that companies are compensated for 75% of any additional expenditure on business rates beyond the amount included in their baselines*'. The final issue of this document should make this clearer.

4 RECONCILIATION OF PR09 INCENTIVES

4.1 INDEXATION IN THE CIS RCV ADJUSTMENT

SEW Summary

Item	*Ofwat Proposal*	*SEW View*
Indexation in the CIS RCV	Adjust PR19 opening RCV for 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.	SEW strongly opposes this change. Approx impact -£25m or circa 2% of RCV.

As stated in the introduction, SEW is opposed in the strongest terms to the proposed CIS RCV adjustment detailed by Ofwat in the consultation.

In the consultation Ofwat refers to representations from Severn Trent highlighting the issue of the operation of the indexation in the CIS RCV adjustment as the reason for the inclusion of commentary in the FD alluding to a future potential adjustment of the RCV. Ofwat also states that a decision was made to maintain the approach adopted for the draft determinations for 2015-20 in final determinations to maintain regulatory certainty. This decision was apparently motivated by the fact that the price review process was nearing its conclusion and that it was too late to introduce a change of that significance.

When reviewing the possible methods for calculating the proposed adjustment, Ofwat states as follows:'*we consider that all three of these approaches could potentially be consistent with the original policy intent set out in the PR09 documentation*'. This suggests that Ofwat had not already defined how the CIS mechanism would work and was now proposing to bring clarity on the implementation of a policy decision made in 2009. However, this justification of the proposed adjustment is inaccurate as it fails to recognise that the issue had not only been identified as early as 2012, but that it had been extensively discussed and challenged by individual companies and in particular SEW. It also fails to recognise that following this engagement, Ofwat made a decision on the indexation in relation to the CIS mechanism which was communicated to SEW and reiterated on several occasions in methodology documents between 2012 and 2014.

It is our view that this was not an oversight or an error on the part of Ofwat that was recently discovered or came to light – it was a thought out policy mechanism, with a methodology published early and clearly with worked examples which were challenged by ourselves and other companies. The same established mechanism applied throughout AMP5 and the price review process, allowing Board decisions on long term investment strategies early in the planning period to be made with an understanding of the impacts these decisions would have on the RCV.

The first mention of a potential change to the RCV was in 'Policy chapter Appendix 4 – reconciling 2010-15 performance'[2] and the PwC technical review of legacy mechanisms[3]. However the potential scale of the proposed change to RCV was not signalled in these documents, and the issue was downplayed in the text of these documents. In their Appendix 4 Ofwat has stated:

> *We would like to engage with stakeholders and consider whether this approach to adjusting for inflation, which may have resulted in a* ***slightly different 2015 opening RCV*** *(as a result of indexation) for all companies, is in the long term interests of customers. It will be appropriate for us to consult shortly on how we approach any adjustment to the RCV at PR19 as a result of indexation. If we consider an adjustment would be appropriate, there would be no need to adjust retrospectively for the revenues received in the interim. These have been correctly set in this price control review, based upon Ofwat's existing approach to inflation. Any change would have a* ***prospective effect only****, and would be applied industry-wide.* (Emphasis added by SEW).

Furthermore, this statement was published well after the decision on CIS had been made and consistently implemented crucially as part of the price review and seemingly ignoring the extensive engagement which had taken place in relation to the confirmation of this mechanism. PwC's technical review also ignored the fact that a clear policy decision had already been made by Ofwat.

We do not dispute that Ofwat can exercise regulatory discretion when implementing its policy decisions, but regulatory certainty requires that when a decision had been made in the exercise of that discretion, such a decision must hold.

The current proposal to adjust companies' RCV is not a way of adopting one of several possible approaches that are consistent with the original policy intent set out in the PR09 documentation in the absence of an existing decision on this aspect; it is in reality a proposal to reverse a clear and unambiguous decision on how this mechanism was to be applied and has been applied before and during PR14.

We dispute the entire premise on which the adjustment is proposed and we demonstrate below that this issue had been extensively discussed and that a clear and unambiguous decision on the implementation of the CIS mechanism had been made by Ofwat and confirmed on several occasions to us and to companies

[2] http://www.ofwat.gov.uk/pricereview/pr14/det_pr20141212legacy.pdf

[3] http://www.ofwat.gov.uk/pricereview/pr14/det_pr20141212legacypwcadj.pdf

generally. We also dispute that an adjustment to RCV would not be retrospective and set out below why it would necessarily have a number of significant retrospective effects.

The process of clarification leading to Ofwat's decision on the CIS mechanism

Appendix 1 sets out a summary of the internal SEW process and the correspondence with Ofwat in coming to a firm understanding of how this mechanism would operate and its impact on our investment strategy. As far back as 2010, SEW were actively seeking to understand how the CIS true-up mechanisms would work in order to set out our investment strategy.

- On 23rd September 2011 we met with Ofwat to seek further details of how the CIS true-up mechanisms would work in practice at PR14.

- In our follow-up letter to Keith Mason, dated 27 October 2011 we emphasised that '*as a key incentive mechanism it is vital we understand the mechanics of the CIS as soon as possible to allow us to effectively balance risk and return as we set our capital programme for the remainder of the current AMP period'*.

- We wrote to Keith Mason again on 10 February 2012 and, using the simplified workings from IN11/08 sought clarification on the precise application using SEW specific numbers in a worked Excel example.

- In the response from Keith Mason, dated 30 March 2012 was a detailed technical feedback note and a worked example in Excel annotated by the Ofwat financial modelling team. Comments to SEW from the financial modelling team were:

  'We have substituted the capex values in the simple illustrative example for your company CIS data and the indicative values in your workings. We have also brought in the pair of RPI inflation lines under the COPI lines in the ex post area of the table and added a final row that converts the net adjustment to RCV from outturn process to 2007-08 prices.'

  '*RCV adjustments – The annotated spreadsheet provides the clarification on the price base issues. It also shows that the RCV adjustment is calculated as the difference between outturn spend and the allowance in the final determination in the projected outturn prices. This deals with the variation in spend and the RPE variation in a one step calculation. We note the stated objective of achieving a net RCV adjustment of zero. Our reworking shows different outturn expenditure values to your workings.'*

- SEW worked closely with Ofwat as they were preparing to issue IN12/08, which included the first worked example of the CIS true-up methodology. We reviewed this methodology prior to publication and at that time highlighted our

> surprise that they were applying different indexation approaches to the RCV and the revenue 'true-up' adjustments

It was made clear to us that Ofwat had settled on this approach and we were told that this was to be the published methodology in the guidance to all companies in January 2013.

On the basis of the clarity and legitimate expectation that the mechanism would be applied as decided by Ofwat recommendations were made to the SEW Board on appropriate levels of investment to make for the remaining years of the 2010-15 period, balancing investment decisions with PR14 incentives and risks.

Since the publication of the methodology in January 2013, we have consistently submitted our calculations and prepared our Business Plan conforming to the established and understood methodology. We are aware that a number of other companies (Southern, Welsh, UU) highlighted the potential issue with indexation in the CIS model during the price review process. They were also told that the CIS model correctly calculated the RCV adjustment and were told to use the established Ofwat methodology.

SEW attended an Ofwat workshop in Birmingham on 9 April 2015: Legacy workshop – Reconciling 2010-15 performance.[4] The objective of the workshop was *'to support companies to understand our approach and our requirements.'* Slide 30 of the presentation clearly states:

> *In revising their business plan submission, companies should:*
> *Use the CIS published on our website which applies Ofwat methodology as intended*

The implications of Ofwat's decision

SEW received express, specific, clear and unambiguous confirmation from Ofwat of how the CIS mechanism would be applied, and its impact on RCV.

SEW requested clarification from Ofwat in September and October 2011 and stated expressly that it was seeking this clarity in order to define its investment strategy in AMP5 with a full understanding of the impact of the incentive mechanism at PR14. It was logical for the company to seek clarification on the mechanics and effects of an incentive mechanism which must be fully understood for the company to be able to act accordingly and for the mechanism to fulfil its purpose.

This issue was discussed in meetings and correspondence with Ofwat. Specific populated models were exchanged with Ofwat to understand exactly how the mechanism would operate including specific calculations. Ofwat received enough information, and had sufficient access to SEW to understand why the clarification was requested and the significance of the confirmation Ofwat provided to SEW. Ofwat had also sufficient information to be able to make any qualification it would have deemed necessary at the time; no such qualification was received.

[4] http://www.ofwat.gov.uk/pricereview/pr14/prs_web20140416legacypr14.pdf

SEW clearly stated from the outset that it would rely on the clarification of the mechanism provided by Ofwat. It was also legitimate for SEW to rely on such clarification received directly from a senior representative of Ofwat with the involvement of the relevant specialist support team at Ofwat. This confirmation on the way the CIS mechanism would be implemented was subsequently reiterated in IN 12/08 and in other methodology documents published by Ofwat between 2012 and 2014. It was also legitimate for SEW to rely on Ofwat maintaining its decision to ensure compliance with the principle of predictability of the principles for economic regulation and having regards to the fact that Ofwat was aware of the significance to SEW of any RCV adjustment. This influenced SEW's investment decisions during AMP5, its assessment of the impact of that investment on the outcome of the next price review, the information provided to finance parties and its assessment of the decision to raise £100m finance with a maturity date of 2037 in October 2012, and its assessment of the long term impact of the RCV valuation well beyond PR14.

SEW had specifically highlighted that Ofwat was applying different indexation approaches to the RCV and revenue "true-up" adjustments in February 2012 and again in May 2012 by reference to spreadsheets exchanged with Ofwat over that period of time, including when commenting on the draft Information Notice 12/08. Having considered SEW's comments, Ofwat confirmed its position in correspondence with SEW and eventually published Information Notice 12/08 which reiterated its approach to the CIS mechanism.

Ofwat had ample opportunities to fully consider the issue and after due consideration made a clear decision on how the CIS mechanism would apply. There was no oversight or mistake on the part of Ofwat, as the issue had been clearly identified by SEW and considered by Ofwat before it provided a detailed response on how the mechanism would operate including actual calculations using SEW's company specific data. From the exchange with SEW in 20111/12 and the publication of IN 12/08 until the publication of the final determinations in December 2014 Ofwat maintained and acted in accordance with its 2012 decision on how the CIS mechanism would be implemented. During that time, Ofwat did not suggest that it would reconsider its decision.

From its outset at privatisation the RCV has always been based on a construct of clearly defined policy decisions and, particularly for the unlisted WoCs – the RCV was defined as a regulatory financial instrument. We are not aware that the RCV has ever been changed retrospectively – changes have only been made through clear and published mechanisms, consistent with best regulatory practice. We are not aware of any situation where a previously published methodology has been reversed, impacting the RCV.

In addition to the comfort provided by both the clarification process and historic precedent, Ofwat as part of the section 13 license modification discussions, committed to companies that the 31st March 2015 RCV would be protected. Ofwat's current proposal would retrospectively erode the value of the 2015 RCV. This seems neither fair nor consistent regulatory practice.

The importance of the RCV in the context of economic regulation was highlighted in the 2012 Competition Commission's final determination in the Phoenix Natural Gas Ltd (PNGL) price control inquiry.[5] This also involved the regulator (NIAUR) proposing material retrospective changes to a regulatory agreement that had been reached between Phoenix and the regulator in 2006. Announcing the Competition Commission's final ruling that only a small revision to Phoenix's regulated asset value (£13.6 million of the £74 million sought by the NIAUR) should be made the Chairman of the Phoenix Inquiry Group and Competition Commission Deputy Chairman, Professor Martin Cave said:

> *"We have been very conscious of the effect of our determination on current household and business bills, but we believe that it is in the public interest to take account of the incentives and rewards required for companies to make investments and take risks, as well as providing incentives for future network investment and expansion—thus meeting the needs of future customers."*
>
> *"Our determination recognizes the importance of including such incentives in the price control and licence conditions. We think it is appropriate for PNGL to be able to earn the agreed rate of return on its investments. We also think that removing elements of PNGL's regulatory asset base, which it had earned under the rules applying at the time, could damage investor confidence."*
>
> *"We think that the long-term public interest is best served by a stable environment that encourages confidence and investment."*

Ofwat was aware that once it had published its decision, companies would act accordingly and would expect regulatory certainty regarding a keystone of the regulatory regime. It was aware of the impact that a change from that decision could have on company's RCV and that this would necessarily cause retrospective unwinding and would be highly undesirable. In respect of SEW specifically, Ofwat knew that its investment decisions in AMP5 and its approach to PR14 were guided by its decision on the application of the CIS mechanism. Once we were clear on the mechanisms to be applied through CIS, long term investment decisions were made balancing the interests of our customers and our shareholders through the then established incentive mechanism. Our Business Plan was centred on customers and the subsequent final determination was made as a package, again focused on customers. However we are increasingly in a world of finely balancing keeping customer bills down whilst allowing investors to earn a reasonable return.

When making its decision on CIS in 2012, Ofwat would have also considered the interests of customers and did so when it made final determinations in 2014 "in the round taking account of the RCV adjustment that companies have received through the 2010-15 CIS true-up, and allowing investors a reasonable return (with scope for out- and underperformance) on that basis". We do not believe that the interest of customers would be detrimentally affected by applying the CIS mechanism as expressly defined by Ofwat in 2012 without future adjustment of the RCV as (i) such an incentive mechanism was designed and implemented in part to protect the

[5] PNGL is the largest gas distribution business in Northern Ireland.
http://www.uregni.gov.uk/uploads/publications/CC_PNGL_final_price_determination.pdf

interests of customers in the long run and (ii) as its impact was fully considered at PR14 which was focused on the interests of customers more than any other price review before it. This latest proposal from Ofwat, is likely to erode the long term certainty and confidence of investors which is essential for securing customers longer term interests. We consider that any short term benefit to customers at the next price review would not counterweight the damage to the long term certainty and confidence in the regulatory process.

Making a further adjustment at the subsequent review could in many respects be seen as 'double dipping' and will have unavoidable retrospective effects.

Unavoidable unwinding and retrospective effect of the proposal on SEW and companies generally

For SEW the Ofwat proposal is very clearly retrospective. At previous price reviews, investments were capped and additional investments not allowed within RCV. We understood through the CIS mechanism that this situation had changed. On the basis of a clear understanding of how the new mechanism was to operate, additional investment when compared to the funded sum was sanctioned by the Board. There was a legitimate expectation by the Board that the expenditure would be included in the RCV at PR14, at the agreed level, and would continue to earn a return in the RCV for the life of the investment. If SEW had known that this treatment was to be reversed at PR19 and the additional investment would no longer be recognised in the RCV, then different investment decisions would have been made. It is difficult to assess the alternative scenario of what could have happened at PR14 had SEW known that this situation were to arise and the additional expenditure not be allowed in the RCV. SEW would probably have spent less, amongst many of the effects of reduced expenditure one would have been that SEW may therefore have been assessed as being more efficient – maybe even a frontier company with the benefits this entails. The baseline assessment for PR14 would then have been different, the level of expenditure allowed different and so on.

Another consideration is that from a customer perspective the final determination may not have been a very different picture in terms of price outcomes had Ofwat made the proposed change at this price review. We believe that prices to customers would probably have been similar, particularly given the tight constraints on financeability in the review. It is unlikely that, had such a reduction to RCV been implemented, the WACC could have been reduced and company determinations remained financeable. Similarly, to make this change at the next price review is likely to have an upward impact on the WACC, as perceived regulatory risk will most likely have increased.

The proposed PR19 adjustment is a one off change and is outside the set number of clearly defined ways in which the RCV could change. Throughout AMP5 we made a number of decisions based on a clearly anticipated RCV at a point in time with only a set number of defined and understood ways that that number might change. We looked at risk and reward over a longer period than just five years and modelled this in our investment model over a much longer term of at least twenty years. Our future key financial ratios and returns to shareholders are derived from this long term model and this was pivotal in informing our PR14 business plan for customers. Ofwat has proposed to make this change at PR19 giving companies' sufficient time over the next period to adjust to the one off change. However, implementing the change at PR19 would not make it in any way less retrospective. In addition, a decision to make an adjustment in the future would have immediate effects on SEW and companies generally. The level of debt to RCV is a key metric for the rating agencies and for our debt covenants. Knowing that this adjustment is coming in 2019 we will have to take further action on our gearing in this period. This may require a further reduction in dividend in the current period, further reducing the legitimate return to shareholders – further indication that this is a retrospective change. Notwithstanding when Ofwat propose to make the change, the rating agencies may take the proposed adjustments into account immediately tightening key ratios in the current period

Following the perceived certainty obtained from the detailed correspondence, set out above, the SEW Board sanctioned additional investment, viewing this as the best course of action for both customers and the long term business, whilst remaining within the framework of the incentive regime. To find that this investment is now proposed to be removed from the RCV and not continue to earn a return seems neither fair nor rational and leaves us in a very difficult position when assessing the current incentive framework and our investment plans for the future.

We do not agree that an "issue" needs to be "remedied". Ofwat is proposing a one off and significant adjustment by just changing the calculation back and reducing the RCV. We believe that such a change would have to take a number of factors into consideration for SEW:

1. Would SEW have invested differently had they known that the RCV would be adjusted as proposed?–
   yes probably and at a lower level with a different risk profile,

2. Would this have affected elements of the business plan bipartite discussions with Ofwat and the determination? – yes on the following:

a. SEW would have been more efficient on the models due to lower historic costs and potentially this carried significant benefits that were unrealised,

b. Would SEW have asked for a different level of future capex and therefore different adjustments? – potentially yes,

c. Would SEW have proposed a different PAYG rate? – potentially yes,

d. Would SEW have proposed a different run off rate? – potentially yes,

e. Would SEW used the position it found itself in to present a different case on the SCP? – potentially yes.

In consideration of the above we strongly oppose an adjustment to the RCV and dispute that Ofwat should consider this option considering that:

- it did not give any consideration to the extensive exchange it had with SEW and to its clear confirmation of how the CIS mechanism would work which was communicated to SEW in 2012 and confirmed thereafter;
- it failed to properly consider the retrospective effects of its proposal and the fact that it would necessarily alter the consequences of SEW investment decisions during AMP5 which were made in reliance of the considered and formal clarifications provided by Ofwat. The implementation of this proposal would be grossly unfair to SEW;
- the proposal to alter the effect of an incentive mechanism after the event is grossly unfair or even irrational in respect of an incentive which is designed to influence companies' behaviour based on the risks and rewards of that incentive; and
- it does not demonstrate that a countervailing public interest would justify its proposal and be such that it could compensate for the detriment to SEW and to regulatory certainty caused by a reversal of its decision.

In conclusion:

- The size of the adjustment that we are talking about can hardly be described as 'a slightly different' opening RCV – it is significant. It is significant relative to our investment programme, our existing RCV and is significant to our business value.
- Clearly, and particularly in our circumstances, we support the do nothing option. We believe that the investment made within an incentive mechanism, explicitly set out in advance by Ofwat, should continue to be allowed to earn a fair return for the life of that investment. We believe that anything else constitutes a U-turn, is unfair and inconsistent and is a clear breach of regulatory certainty.
- If, however, Ofwat concludes that short term customer interests take precedent over their long term interests resulting from long term investment and regulatory certainty then we believe there is a number of additional factors that Ofwat would need to give careful consideration to in coming to a more balanced proposal.

4.2 THE CONSTRUCTION OUTPUT PRICE INDEX (COPI) INDEX USED IN THE CIS MODEL

<u>SEW Summary</u>

Item	*Ofwat Proposal*	*SEW View*
COPI	Adjust for COPI when accurate data becomes available (for example, in 2016).	Reasonable approach.

We are aware of the difficulties with the COPI index and are happy with the proposed approach.

However, we believe that the RCV CIS indexation issue discussed the previous section is further confounded by the whole usage and treatment of COPI. We can appreciate the reasons that Ofwat have dropped the usage of COPI for PR14 and onwards. Throughout the period 2010 to 2015 there have been a number of complicated issues identified with the calculation and application of COPI and the index has been revised a number of times. It is difficult to know how reflective the COPI index is of real costs and as a consequence whether customers are paying more or less that they need to. With the variability in the COPI index and its use in the incentive mechanism we believe that this is a further reason that Ofwat should stick with the mechanism that was clearly defined in advance for the CIS adjustments. We do not believe that there has been enough certainty around the precise indices applied for 2010-15 for Ofwat to then move retrospectively to a different mechanism.

4.3 2014-15 'BLIND YEAR' ADJUSTMENTS

SEW Summary

Item	*Ofwat Proposal*	*SEW View*
Blind year	Include a materiality threshold for the blind year adjustment. +/-2% of 2014-15 turnover for revenue +/- 0.5% company opening 2014-15 RCV	Agreed

We are happy with the proposals on the blind year adjustments and support the use of a materiality threshold.

5 HOUSEHOLD RETAIL

Summary

Item	*Ofwat Proposal*	*SEW View*
Reconciliation	Include a wash-up between allowed and outturn revenues in PR19.	Agreed
Discounting Time value of money	Only adjust for time value of money for 'material differences'.	Unreasonable and inconsistent. Ofwat need to be clearer on what constitutes 'material differences'.
Tax	Do not adjust for taxation.	Only reasonable where tax has already been allowed.

SEW is metering a lot of customers in this period. With such a movement in properties from unmeasured to measured it is more likely that there will be some variation from our FD forecast that for a company with is not undertaking such a program.

Ofwat has indicated that they will only apply the time value of money to material differences between allowed and outturn household retail revenues. We don't consider that it is reasonable for Ofwat to publish a rulebook in this area but then say that they *'do not consider that it is appropriate to set out the definition of material at this stage'*.

We do not see any reason why the retail mechanism should not be consistent with the wholesale proposals in terms of adjusting for the time value of money. Given our circumstances as described above we consider that:

- Ofwat should allow for the time value of money
- Ofwat should set out the materiality limit, if there is to be one, within the published rulebook.

6 GENERAL COMMENTS

We have some concerns over the approach and timescale of this consultation. We consider that the consultation period of 6 weeks is insufficient considering there are eight individual mechanisms, each with their own detailed Excel models to be assessed.

Our process of understanding the mechanisms of the capital incentive scheme (CIS) in sufficient detail for PR14 took place over a number of months and years. We also spent a significant amount of time reviewing the AMP5 revenue correction mechanism (RCM) with Ofwat.

We would like Ofwat to set out, in its final rulebook and consultation summary, the process by which future queries and clarifications can be made by Companies. We think that this will be particularly relevant to ODIs, which are mainly company specific and somewhat bespoke.

7 ANNEX 1 – TIMETABLE OF CORRESPONDENCE WITH OFWAT ON PR09 CIS AND OFWAT PUBLICATIONS ON PR09 CIS

Correspondence	Component	Approach	Consistent with FD models	Consistent with new proposal
Meeting with Ofwat 23-9-11	CIS mechanism generally	Discussing the interaction of COPI and the capital incentive scheme (CIS).		
JS (SEW) to KM (Ofwat) 27-10-11 confirming SEW understanding from meeting at Ofwat 23-9-11	RCV true-up	'*Whilst we found the discussion somewhat revealing as to Ofwat's potential approach we still believe there is a lack of clarity and consistency which is hampering us in understanding the potential financial impact of our decisions.'* '*As a key incentive mechanism it is vital we understand the mechanics of the CIS as soon as possible to allow us to effectively balance risk and return as we set our capital programme for the remainder of the current AMP period.'* '*You stated that you would compare actual outturn capex to that funded (in outturn prices) in the RCV and adjust RCV upwards or downwards according to that comparison*.' This was effectively achieved – however the differences in outturn prices were deflated using actual average RPI in order to get the outturn differences to a common price base.	✓	×
	Revenue – Return true-up	*'For the purposes of these adjustments you stated that actual Outturn capex would be compared to the capex funded in the RCV, inflated for actual RPI. You also expressed doubt that there would be any ex post IRC or CCD adjustment '* *In a way this was achieved, however instead of inflating 'allowed RCV capex' by actual RPI to get to outturn – the actual outturn capex was deflated by average RPI. So instead of being compared at outturn prices they are compared on the same basis at 2007-08 prices. There was no IRC/CCD adjustment.*	✓	×
KM (Ofwat) to JS (SEW) 20-12-11	RCV true-up	This letter refers to the calculation of the CIS ex post ratio reward/penalty – it is consistent with how it was applied at FD. This letter does not mention the RCV		

Correspondence	Component	Approach	Consistent with FD models	Consistent with new proposal
responding to SEW 27-10-11 letter		true-up mechanism.	-	-
	Revenue – Return true-up	This letter does not mention the return true-up mechanism.	-	-
Ofwat issue *IN 11/08 Changes to COPI* 23-11-11	RCV true-up	*'The fact that outturn COPI will inevitably be different to that assumed when we set price limits has no direct impact on any reconciliation of a company's RCV at the end of the price control period. This is because, at the end of the price control period, a company's outturn capital expenditure is included in its RCV, replacing that which we assumed when we set price limits.'*	✓ (but detail unclear)	×
JS (SEW) to KM (Ofwat) follow up letter 10-2-12	General	SEW highlighted the impact of indexation using outturn COPI and RPI combined and asked for confirmation of the intended approach in more detail. Further details on revenue return true-up mechanism requested.	-	-
KM/DH (Ofwat) to JS (SEW) 30-3-12 Response to SEW 10-2-12 letter including detailed technical feedback note and worked example in Excel from Ofwat Financial Modelling team.	RCV true-up	'*The RCV adjustment is calculated as the difference between outturn spend and the allowance in the final determination in the projected outturn prices.'* This is consistent with the FD approach but it omits the step to move from outturn to a constant price base using actual average RPI. Extracts from - Feedback to SEW from the Financial Modelling team – Ofwat March 2012 ***'Illustrative example with SEW data*** *We have substituted the capex values in the simple illustrative example for your company CIS dat and the indicative values in your workings. We have also brought in the pair of RPI inflation lines under the COPI lines in the ex post area of the table and added a final row that converts the net adjustment to RCV from outturn process to 2007-08 prices.'*	✓	×

Correspondence	Component	Approach	Consistent with FD models	Consistent with new proposal
		'RCV adjustments *The annotated spreadsheet provides the clarification on the price base issues. It also shows that the RCV adjustment is calculated as the difference between outturn spend and the allowance in the final determination in the projected outturn prices. This deals with the variation in spend and the RPE variation in a one step calculation.* *We note the stated objective of achieving a net RCV adjustment of zero. Our reworking shows different outturn expenditure values to your workings.'*		
	Revenue – Return true-up	'Calculated as the difference between the gross capex funded and the company's outturn (ie the difference in gross capex times the cost of capital)'.	Unclear	Unclear
RL (SEW) email to DH (Ofwat) 9-5-12		Request to clarify Revenue – Return true up. Querying differences in indexation between RCV adjustment and Revenue return component: *'I have to say that I don't understand the reasons for adjusting the RCV using both outturn expenditure and original FD allowance in outturn and yet when you are adjusting for the revenue component of the same you are using 2007-08 NI actual versus 2007-08 FD NI'.*	-	-
DH (Ofwat) email to RL (SEW) 28-5-12	RCV true-up	Annotated comments and worked spreadsheet showing RCV adjustment calculated as outturn / Actual Av RPI. This worksheet is consistent with the methodology published in IN/12/08.	✓	×
	Revenue – Return true-up	Calculated as the difference between: Outturn capex / outturn average RPI and FD capex * FD COPI / FD RPI.	✓	×
Web page referencing Ofwat documents relating		This is the first issue of a summary of documents relating to the CIS mechanism. It does not say anything in itself other than reference other documents on this schedule.	-	-

Correspondence	Component	Approach	Consistent with FD models	Consistent with new proposal
to the CIS. 24-7-12		It has been updated since for subsequent publications.		
Ofwat Issue IN12/08: The CIS and the RCM – FAQs 31-7-12	RCV true-up	Introduces *Ofwat's approach for calculating CIS true up adjustments – flowchart* In Ofwat's information note the RCV adjustment calculation is defined as: *'Actual capital expenditure – Allowance capital expenditure adjusted for FD COPI assumptions'.* *'We are preparing a fully functioning spreadsheet model to perform the CIS reconciliation as illustrated in the flowchart. We will use it to calculate for each company:* *- the reward/penalty revenue adjustment; and* *- the RCV adjustment.* *We will publish the CIS true-up adjustments model alongside our consultation on our proposed methodology for setting price limits for 2010-15.* *We plan to publish this in autumn 2012.'*	✓	×
	Revenue – Return true-up	In the flowchart the financing adjustment calculation is clearly defined as: 'Financing cost on under/overfunded gross capex = Capex under/overfunded (difference between actual capex in 2007-08 prices (using outturn notified index) and allowance capex in 2007-08 prices (using FD NI assumptions)) x PR09 post tax rate of return (vanilla)'	✓	×
Spreadsheet model for calculating the CIS true-up 31-1-13	RCV true-up	This is the first issue of the model used as the CIS true-up feeder model – it is the model structure used for FD.	✓	×
	Revenue – Return true-up		✓	×

Correspondence	Component	Approach	Consistent with FD models	Consistent with new proposal
CIS true-up feeder model 20-2-14	RCV true-up	Same as above.	✓	✗
	Revenue – Return true-up		✓	✗
Ofwat technical workshop on Legacy Adjustments including CIS true-up feeder model 9-4-14	RCV true-up	Same as above. Emphasising that this model should be used and that no alternative proposals would be acceptable in Company Business Plan submissions.	✓	✗

An Ofwat summary of documents relating to CIS is available here:
http://www.ofwat.gov.uk/regulating/prs_web_cisdocs