



# South Staffs Water

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PR14 Reconciliation Rulebook consultation,  
Ofwat,  
Centre City Tower,  
7 Hill Street,  
Birmingham,  
B5 4UA

7 May 2015

Dear Sir,

South Staffs Water is pleased to submit our response to the Ofwat consultation on the PR14 Reconciliation Rulebook.

Each of the mechanisms contained within the rulebook is discussed in turn below:

## **Outcome Delivery Incentives (ODI) mechanism**

Overall, the Company supports the recommended approach for the ODI mechanism. The Company agrees that there is little sense in applying time value for money to a reward/penalty as it is not a cost or benefit that has been incurred by companies or customers. Equally, providing a tax allowance for ODIs is probably the correct approach as they are not covered by the tax allowance within the Final Determination.

In respect of asset health ODIs, the Company submitted a detailed calculation methodology showing how the points from the various sub-indicators would accumulate and form the top level assessment. The Company is intending to publish a customer friendly version to improve clarity to stakeholders.

## **Totex menu reconciliation**

The totex menu reconciliation is generally in line with how the Company expected it to operate. However, in the Final Determination, the initial reward/penalty is shown as a deduction in wholesale allowed revenue, whereas in the illustrative spreadsheet, the reward/penalty is rolled into the total totex adjustment which is then split using the PAYG rate. This means that the treatment of the initial reward/penalty will change with part of it being a reduction in RCV. This potential change in methodology from the Final Determination needs to be clarified so companies can understand how revenue and in particular RCV will be affected, especially in light of the PR09 CIS reconciliation.

In testing the illustrative spreadsheet, the output includes the reward/penalty already received in the Final Determination. This means that the adjustment shown on the 'totex menu adjustments' worksheet is a combined PR14/PR19 position rather than the adjustment that would be made at PR19. It would help users of the model if the output could split the adjustment to show what the reward/penalty at PR19 would be.

## **WRFIM**

Overall, the principals of the WRFIM are in line with the April 2014 consultation and policy chapter A7 of the Final Determination and the Company agrees with the approach. However, there are a couple of points, having tested the model, that the Company would like to raise.

The RFIM calculation in the published model combines both the under/over recovery of revenue and the penalty if above the threshold. This is then adjusted for both inflation and the time value of money. This makes it unclear what the amount of the RFIM adjustment relates just to the penalty. The Company thinks it would be useful if the penalty element could be shown separately in the model.

In testing the spreadsheet model, there appears to be an error in the way the RFIM adjustment is uplifted to outturn prices (worksheet 'WFRIM – water', Line 39). When uplifting to outturn prices plus two years, it is using the cumulative RPI from November 2012 for each of the two years rather than just the annual RPI in the two particular years.

For example, the adjustment for 15-16 is uplifted by multiplying cumulative RPI from November 2012 for 2016-17 and 2017-18 ( $1.1187 * 1.1567 = 1.294$ ). We believe that this should actually be the annual RPI rates ( $1.028 * 1.034 = 1.063$ ).

## **Water Trading Incentives**

The Company is comfortable with how the water trading incentive works and has no additional comments.

## **Household retail mechanism**

The principals of the household retail mechanism is in line with chapter A5 of the Final Determination and the Company agrees that differences should be small as Company's reforecast their customer numbers each year and hence there is no need for a forecasting incentive mechanism.

In reviewing the spreadsheet model, the units in which some of the values are presented are incorrect. In particular, the revenues in the 'calcs' worksheet are in £s rather than £m's as classified in the model.

On P56 of the draft reconciliation rulebook, the first line of the input table (4.4) refers to forecast customer numbers from the Final Determination. These inputs do not appear in the spreadsheet model.

### **Uncertainty mechanisms**

The Company is comfortable with the uncertainty mechanism for water business rates and has no additional comments.

### **Reconciling 2010-15 performance: 2014-15 adjustments**

Having reviewed the illustrative spreadsheets, the Company is happy with how the models reconcile 2014-15 performance. The Company also supports the overall materiality of any impact on revenue and RCV. This makes particular sense as the Final Determinations included companies' latest forecasts for 2014-15 and so should be relatively accurate to the actual outturn.

For South Staffs Water (SSC), these mechanisms will need to be completed separately for both South Staffs Region (SST) and Cambridge region (CAM) as they are a PR09 legacy adjustment. The Company will report by region in its regulatory accounts for 2014-15 to ensure the data is available.

There is one concern regarding any change to the basis of COPI following review by the Department of Business Innovation and Skills (BIS) and how this might be used with regards the CIS true-up for PR09. In order to avoid any regulatory uncertainty, Ofwat should confirm that if a new COPI index is published, it will not impact on the CIS models used for 2010-2014 Q1 where previously published data has already been used. It should only apply to the data points from 2014 Q2 where a forecast of COPI had to be used for the Final Determination.

### **Indexation in the CIS RCV adjustment (PR09 CIS reconciliation)**

The impact of changing the approach to the PR09 CIS reconciliation is significant for the whole industry. For South Staffs Water, the adjustment would result in a £8.0m reduction in RCV at March 2020. This is the largest percentage reduction in RCV in the whole industry (2.4% reduction compared to an industry average of 1.8%).

When feedback was received from the risk-based review on the 24 March 2014, it stated that the Company 'did not submit populated copies of the published CIS true-up model'. This was followed up with a workshop held by Ofwat on the 9 April 2014 where companies were told to 'use the CIS published on our website which applies Ofwat methodology as intended'. The Company therefore utilised these models published by Ofwat in its updated plan to Ofwat in June 2014. However, it was not until the Final Determination was issued in December 2014 that any reference to a potential issue with this calculation was raised.

Appendix A4 of the Final Determination recognised that there were alternative ways of calculating any adjustment for indexation, however Ofwat robustly defended the adopted approach. Therefore, whilst the Company recognised that Ofwat stated ‘that 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’, the Board of South Staffs Water had a reasonable expectation from using the published model and methodology and the defence of this by Ofwat that the consultation, when it took place, would only have had a slight impact, rather than the significant impact on RCV that this document proposes. Therefore, the Company on balance, having considered the challenges carefully accepted the Final Determination in the round as a whole package, recognising that there were pros and cons within that overall package

The Company also has concerns about the impact that this proposed change to RCV has on the trust and confidence of investors in the regulatory process and therefore the potential long term negative impact that this could have on customers given the continued investment required in the sector.

Therefore, the Company does not believe that it is in the correct spirit that elements of the Final Determination should be re-opened. This is especially the case here, where Ofwat have acknowledged that there are other alternative ways in which the CIS methodology could have been applied. The Company would therefore propose that the ‘do nothing’ option is adopted.

If, however, following the consultation and in spite of the reasons set out above, Ofwat continue to believe that an adjustment to RCV is required, the Company requests that Ofwat consider phasing the impact in over the five year course of AMP7 rather than as a ‘midnight’ adjustment in March 2020.

Please do not hesitate to contact me if you have any questions or comments on our response.

Yours faithfully,

Philip Saynor,  
Director of Finance and Regulation  
South Staffordshire Water PLC