SOUTH WEST WATER

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PR14 Reconciliation Rulebook
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Our ref:

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Dear Sir,

CONSULTATION ON THE PR14 RECONCILIATION RULEBOOK

We are pleased to provide our response to the consultation on the PR14 Reconciliation Rulebook. We welcome the clarity provided for companies by the draft rulebook and accompanying spreadsheets. The options in the consultation were presented very clearly and set out in an easy to understand way and this has enabled us to reach a considered view across the range of proposals.

In the vast majority of cases we agree with the assessment of the options and the conclusions drawn on the mechanisms. The right balance has been made between the need for consistent reconciliation tools and ones that are straightforward to implement. We believe in some cases it may be possible to establish technically more "perfect" approaches, but we agree that there are also risks from additional complexity. We think it is helpful these choices and the reasons for them, are set out and agreed now, to avoid the options being revisited at the end of the review period.

In the appendix to this letter we have set out a schedule summarising our views on all of the option areas set out in the consultation. Where relevant we have provided analysis which supports our conclusions.

The most difficult question in the consultation is the proposal to adjust the RCV in 2020 for a change in the way inflation is applied in the PR09 Capital Incentive Scheme Model. The South West Water (SWW) Board has considered this issue very carefully and agreed that if the differential application of inflation is a technical error, then it should be corrected if it is in the best interests of customers. In these circumstances the approach proposed in the consultation is the best way of achieving this.

However, in the final version of the PR14 Reconciliation Rulebook it would be helpful to provide evidence why this use of inflation was an error. This avoids the risk that other inconsistencies (such as those in the PR14 rulebook on inflation and the time value of money) could be considered errors in the future. This is important as customer and stakeholder interests are only served by correcting clear errors, as retrospective changes would not be in their interests as this risks undermining confidence and certainty in the regulatory regime.

The consultation suggests that the "Pay As You Go" rate will be applied to the total totex incentive adjustment for wholesale costs at PR14 to calculate between revenue and RCV correction components, including both cost variation, financing adjustment for the time value of money and menu reward/penalty. We think it is incorrect to include the menu reward and penalty within the RCV adjustment as the menu reward should solely be included in the revenue element, in line with the application with the up-front menu reward/penalty at PR14. As we show in the appendix to this letter, this provides for a smoother change in customer bill impact, principally because PAYG rates are broadly similar to menu reward rates across the industry. Our customer research and engagement indicates customers have a preference for smooth bill changes where this is enabled by regulatory mechanisms.

The consultation also suggests that the Wholesale Revenue Forecasting Incentive Mechanism (WRFIM) will be based on a comparison using November RPI (from 2012 to the relevant year) as this is consistent with the inflation used in setting K values at FD14. In the original WRFIM consultation conclusions, although the forecasting incentive was to be inflated using November RPI, the final correction at the next price review would be based on an average RPI comparison. This is consistent with the expression of base revenues at FD14, which was based on forecast 2015/16 average RPI deflated by forecast November 2014 RPI, to reflect that the wholesale allowed revenues were calculated at average RPI. We think that the eventual adjustment at the next price review should remain based on an average RPI basis to the wholesale revenues allowed at FD14.

We are happy to discuss any aspects of our response to the consultation.

Yours faithfully,

Iain Vosper

Regulatory Director

APPENDIX: SUMMARY OF VIEWS

Issue	Ofwat Proposed Approach	SWW comment	Statutory Duty reason for comment
Outcome delivery incentives			
Indexation	Use actual average year RPI to inflate PR14 values to PR19	Agree	
Time value of money	Do not adjust for time value of money	Agree	
Taxation	Allow taxation on ODI rewards and penalties as part of PR19 review	Agree	
Aggregate cap and collar	Do not adjust ODI rewards and penalties for taxation comparison with cap	Agree	
Scheme ODIs	Major scheme ODI assessment rules	Agree	
Asset health ODIs	Require companies to publish further details for asset health measures where these are not included in PR14 final determinations	South West Water is included on the list of asset health ODIs. Our serviceability measures are based on the PR09 metrics and the methodology was included in our business plan. We will publish the information on our web site as part of our ODI reference document	

Issue	Ofwat Proposed Approach	SWW comment	Statutory Duty reason for comment
Wholesale – totex			
Definition of totex for menu sharing	Exclude items not included in the menu baseline – third party costs, pension deficit recovery and transition costs	Agree	
Indexation	Deflate future year total expenditure using actual RPI for comparison for PR14 allowances	Agree	
Allocation of totex outperformance and underperformance to revenue and RCV	Allocate outperformance and underperformance using weighted average PR14 PAYG rate, with companies providing robust evidence for changes that are in customers' interests.	We agree for allocation of outperformance or underperformance expenditure, but revenue reward / penalty for outperformance or underperformance should by default be through revenue rather than the PAYG rate applying. This results in a much smoother change in customer bills. **See example 1**	Improves regulatory consistency with FD14 application. Represents a balance in terms of timing of change between efficient financing of functions and customer bill changes, which is in customers' interests.
Time value of money	Adjust for time value of money for customer sharing outperformance / underperformance	Agree	

Issue	Ofwat Proposed Approach	SWW comment	Statutory Duty reason for comment
Taxation	Include a taxation adjustment for RCV changes only	Agree – but only as noted above if the reward / penalty element is included in revenue (and is treated post tax) – to ensure the full incentive properties are applied. In line with the up front revenue adjustment at PR14 which was post tax. Menu rewards / penalties should receive a tax allowance for the incentive properties to be maintained. Our approach on allocation between revenue and RCV components would allow for this to be reflected. This would be consistent with the up front revenue adjustment and the CIS mechanism at PR09.	As above – regulatory consistency with FD14 approach for eventual correction is in customer interests.
Wholesale - WRFIM			
In period ODIs	Exclude revenue changes from in-period ODIs from WRFIM reconciliation	Agree	
Taxation	Do not include taxation adjustments in PR19	Agree	
Blind year	Include blind year adjustment in PR19	Agree	

Issue	Ofwat Proposed Approach	SWW comment	Statutory Duty reason for comment
Inflation	Proposes indexing using Nov – Nov RPI	Eventual calculation should use average RPI to be consistent with FD14 and WRFIM consultation proposals. **See example 2**	Consistency with original WRFIM consultation and format of FD14.
Water trading incentives			
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	Does not affect SWW	
PR09 reconciliation			
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.	Agree – providing that Ofwat clearly set out the reasons that the differential use of inflation was a technical error rather than just inconsistent. **See example 3**	Customer interests are served by correcting technical errors, balanced against the risk that changes are seen as retrospective and not consistent with the understanding that companies had (and confirmed with Ofwat) of the regulatory framework.

Issue	Ofwat Proposed Approach	SWW comment	Statutory Duty reason for comment
COPI	Adjust for COPI when accurate data becomes available (for example, in 2016)	Agree	
Blind year	Include a materiality threshold for the blind year adjustment	Agree. We question whether the RCM is included within the materiality calculation, given that it is to be adjusted in 2016/17 rather than at the end of the period. The WRFIM section does suggest that the RCM adjustment could be delayed because of COPI, but we think this is not in customer interests and should take place in 2016/17 in any case (as COPI is not necessary for this adjustment providing the materiality threshold does not include RCM)	Clarity suggested for the consultation conclusions on this point. Revised proposal for RCM is in customer interests and in line with stated intention of adjusting for RCM in 2016/17 and other blind year adjustments at PR19.
Household retail			
Reconciliation	Include a wash-up between allowed and outturn revenues in PR19	Agree. Spreadsheet requires correction for £m vs £ * customer numbers	
Time value of money	Do not adjust for time value of money	Agree	
Taxation	Do not adjust for taxation	Agree	
Gain Share Mechanisms	Up to companies to ensure that these do not conflict with regulatory mechanisms	Agree. South West Water has considered this carefully with WaterShare. **See example 4**	

Example 1: Allocation of totex outperformance and underperformance to revenue and RCV

We have the following technical comments on the proposed totex menu approach:

- the overall PAYG rate is weighted by the baseline totex, but the adjustments are net of menu exclusions. This could be amended, but for simplicity purposes we agree with the approach taken
- the totex spreadsheet currently includes the revenue adjustment as a net adjustment through the menu, rather than working out the expenditure adjustment and then netting the revenue amount off the PAYG element (i.e. with the Capital Incentive Scheme and up-front menu adjustment at PR14, the menu adjustment is revenue even if the menu choice affects capex)
- a revision to the menu incentive element would also fit with the logic of the tax adjustment approach – a tax allowance on the reward or penalty for totex outperformance / underperformance at the net sharing rate should be allowed at PR19 (similar to the CIS revenue adjustment and up front menu adjustment at PR14)
- this approach should reflect a smoother change in customer bills, given that reductions in operating cost from the efficiencies form a new PAYG base at PR19 and reduce revenues then. The table below shows a comparison of the two approaches for one example we tested through the totex adjustment spreadsheets. The total expenditure variance is the same but there is a smoother bill change as the PAYG base cost change is offset by the base cost change, at the cost of a higher RCV adjustment.

AMP6 totex variation only (12/13 prices)	**Ofwat consultation approach**	**SWW suggested amendment**
PR19 revenue adjustments		
Water	-13.3	12.2
Wastewater	-23.9	4.8
Total	-37.2	17.0
PR19 RCV adjustments		
Water	-9.2	-34.6
Wastewater	-20.3	-49.1
Total	-29.5	-83.7
PAYG 2020 base cost change		
Water	-8.7	-8.7
Wastewater	-9.1	-9.1
Total	-17.8	-17.8

The totex model currently includes the up-front menu incentive revenue income reward / penalty received at PR14 within the input allowed totex. It would be more transparent and easier for the user to split these two inputs out, so that comparison of allowed total expenditure to actual total expenditure was made on a like for like basis, with the up-front menu incentive deducted from the final menu calculation of the total incentive adjustment.

Example 2: Inflation in WRFIM

The inflation included in the WRFIM model uses November 2012 to November for the charging year. Whilst this is the correct index to be used for the forecasting incentive calculation, the WRFIM consultation concluded that average RPI should be compared for the eventual PR19 true-up in line with the average RPI basis used for wholesale revenues at PR14.

The FD14 base wholesale revenues were presented in year average prices and the base allowed revenue was FD RPI to 2015/16 then deflated to form a 2014/15 base plus the K in the future years from this allowed revenue. The same approach should be used for the eventual WRFIM true-up.

The WRFIM model will also need to allow for adjustments to forecast revenues that are accepted by Ofwat as variations that are in customers interests. For instance, SWW returned £4m of additional 2014/15 revenues to customers in setting 2015/16 charges, rather than waiting for the automatic correction in 2016/17. This was accepted as a valuable use of revenue flexibility which should not inadvertently result in a WRFIM forecasting penalty with the benefit of hindsight.

Example 3: Indexation in the CIS - RCV

It can be argued that the approach to the CIS indexation was understood in advance of PR14 and the inconsistent use of inflation between the expenditure and financing adjustment was intended. Other than considering that one method of introducing consistency in the use of inflation (the Severn Trent approach) would increase customer bills and the preferred Ofwat approach would reduce customer bills, there is no specific recognition in the consultation or the PWC report that the PR09 CIS spreadsheets contained a technical error.

However, companies including SWW challenged the CIS inflation approach on a number of occasions during PR09 and received specific confirmation from Ofwat that the inflation approach was intended, despite its inconsistencies. The logic for the original approach was that financing rates of return in the original FD09 had been set based on the inflation assumptions at the time. However, if Ofwat do believe that this approach represents a technical error, then it is in customers' interest to adjust this through the RCV in 2020 as Ofwat propose.

We believe that in this one instance, Ofwat could conclude that the differential use of inflation was a technical error. The use of inflation for the RCV adjustment differs from the financing adjustment wasn't sufficiently clear in the PR09 documentation or the CIS spreadsheet to conclude that the FD14 outcome was that originally intended.

The arguments around the Ofwat approach to the RCV adjustment are finely balanced.

A key question is whether Ofwat's proposal amounts to a retrospective change, and even if it is, whether this can be justified. The justification for retrospective changes to the RCV was considered by the Competition Commission (CC) in the 2013 Northern Ireland Electricity appeal. In this case the Utility Regulator was not allowed to retrospectively change the RCV from a prior review period. However, the CC found that it would be appropriate to do this (and there was regulatory precedence to support this):

> "*where an error of a technical nature had been made, and as a result consumers pay more for services than they should*"

This suggests ultimately that it is in the public interest to correct the indexation as Ofwat propose in 2020. Therefore as long as Ofwat can confirm that an error of a technical nature was made in the way that inflation was originally applied to the RCV adjustment at FD14, it is consistent with Ofwat's duties to make a correction. An adjustment in 2020 makes this a prospective rather than retrospective adjustment.

Example 4: Operation of WaterShare with regulatory mechanisms

WaterShare operates outside of the regulatory mechanisms but was inherent to the SWW PR14 plan. It shares net gains with customers (e.g. pains for company), with a choice of bill reduction (e.g. offsetting ODI in period gains) and reinvestment for any net gain sharing. Transparency is delivered using an independent chair of a WaterShare representative panel with independent assurance. The panel oversees SWW performance and the context of how outperformance and underperformance is dealt with.

The expected interaction with the regulatory mechanism includes:

- WRFIM – if revenue is passed back to customers then no under-recovery penalties would be expected – SWW would be able to demonstrate to Ofwat that this was in customer interests (in advance of the tariffs being set).
- at PR19:
  - there is the potential for reinvested totex not to be trued up in the RCV
  - there is the potential for revenue adjustments for totex outperformance / WRFIM not to be made
  - in period ODI rewards that were not taken up in bills during the period may be corrected for subsequently.

However, the intention is for no change to regulatory mechanisms because of WaterShare, other than voluntary sharing that benefits customers and forms part of proposals in the SWW PR19 plans. The WaterShare mechanisms take into account the working of the regulatory mechanisms in deciding how net gain for customers is shared. The sharing from reinvestment takes into account that there is a menu sharing rate that is the company "hit" from reinvestment.