Your ref

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Our ref
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Contact
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Dear Cathryn,

Consultation on the PR14 reconciliation rulebook

I am writing in response to your consultation on the PR14 reconciliation rulebook.

We welcome the publication of the rulebook as an important step in ensuring all stakeholders are clear on the mechanics of the various PR14 incentive mechanisms and how they will be reconciled, well in advance of PR19. We support most of the proposals contained within the rulebook which strike a good balance between precision and simplicity. Our limited comments on these are set out in the appendix to this letter.

The remainder of this letter focuses on the new proposal within the rulebook to adjust all companies' Regulatory Capital Values (RCV) at the next price review in respect of performance during AMP5; an adjustment that would see the RCV of the sector reduced by 2% or around £1.2bn.

The emergence of this issue so soon after the conclusion of PR14 is concerning. Ofwat's actions and approach to engagement led to the industry being taken by surprise on a very material issue. It is essential that lessons are learned from this episode as Ofwat builds its approach for future engagement with the sector.

As you are aware, Southern Water drew Ofwat's attention to the RCV reconciliation issue that is now the subject of consultation back in December 2013. We were told categorically that the application of indexation in Ofwat's model was as intended. That correspondence between Ofwat and the company created a very clear expectation on how the RCV would be reconciled in PR14; correspondence which our Board, evaluating the final determination in the round, relied on in reaching its decision not to seek a referral of the final determination to the Competition and Markets Authority.

Ofwat's consultation argues that because the final determination for AMP6 is not changed, the proposal has no retrospective effect. This is not the case. The PR14 final determination set company expectations on how AMP5 capex would be reconciled into the RCV. The proposal contained in the consultation in fact seeks to re-make that decision at PR19, with the effect that it undermines the expectations previously set.

Furthermore, the proposed change will inevitably affect companies' behaviour in AMP6, as we will need to make provision for a very material adjustment to the RCV (and associated gearing levels) at PR19. Our Board considers that, if a change in methodology is to occur at all, it should be done in a way which has no impact on any critical financial metrics. For the reasons already cited, Ofwat's current proposals will clearly affect that aspect of our accepted PR14 determination.

A strong, long-term regulatory commitment to the RCV has been instrumental in enabling the water sector to access low-cost, long-term funding, to the benefit of customers. Altering the perception of investors about the strength of this regulatory commitment, which the current proposals risk doing, would not serve customers long-term interests, even if there were some short-term customer benefit.

Given that the proposal does not achieve Ofwat's intention to have no retrospective effect, we would strongly urge Ofwat to re-consult on a broader range of options for change which mitigate the impact of the current proposal.

Southern Water is committed to playing its full part in helping to resolve effectively the current predicament Ofwat and the industry face in relation to RCV reconciliation and in ensuring that all reasonable options are considered.

More generally, I would like to suggest that we work together to reach a shared view on the accuracy of the new suite of models that have been published alongside the rulebook, to avoid the risk of a recurrence of any RCV reconciliation type issue at PR19. We would be happy to work with Ofwat to convene a working group of industry modelling experts to review each of the published models in detail. Once that group is content that the models are consistent with the stated policy purpose, Ofwat would then be able to commission a third-party audit of the models as a final assurance step. Having been through that rigorous process of validation, Ofwat could then confidently commit to not changing the models for PR19.

I am confident that by working together and engaging in further dialogue we can reach a more considered and balanced position on this key issue for the sector. I am of course happy to discuss any aspect of our response or proposals for working together with you in more detail.

Yours sincerely

Matthew Wright
Chief Executive Officer

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Appendix 1: Southern Water's response to Ofwat's consultation on the PR14 reconciliation rulebook

Our main response focuses on the most material issue in the consultation, the proposals to adjust the RCV at PR19. This appendix provides brief additional comments on the remaining proposal in the consultation. In most cases we are broadly supportive of the proposals in the consultation. The key exceptions are:

- We do not believe Ofwat should retrospectively introduce a materiality threshold for the PR14 blind year true-up. As we show below this would have a material adverse impact for Southern Water; an impact that is inconsistent with the previously stated policy.
- We do not support the proposed treatment of tax associated with Outcome Delivery Incentives (ODIs), which would effectively increase the level of ODI risk that we face, relative to that set out in the final determination.

A. Outcomes (Appendix 2 of consultation document)

(i) Treatment of inflation

Ofwat's proposed approach:

- Use actual average year RPI to inflate PR14 values to PR19

SWS view:

- We agree that using FYA RPI to index rewards and penalties from 2012-13 prices to 2017-18 prices is appropriate.
- We do not have any in-period ODIs; however, we think it is sensible to use published actual November RPI figures, as proposed, rather than forecast data.

(ii) Treatment of time value of money

Ofwat's proposed approach:

- Do not adjust for time value of money

SWS view:

- While there is a good theoretical case for taking account of the time value of money, we agree that this is an unnecessary complexity that is unlikely to have a material impact.

(iii) Treatment of taxation

Ofwat's proposed approach:

- Allow taxation on ODI rewards and penalties as part of PR19 review

SWS view:

- We think the most appropriate approach would be to not make any tax allowance for ODI rewards and penalties. This is consistent with our understanding of the basis of the final determination, which did not raise the prospect of a further increase in what for Southern Water are very considerable penalties.

- The consultation notes that the proposal would mean a net positive effect for customers, simply because final determinations include more penalties than rewards. We do not think that is a robust or acceptable justification for a change of this type.
- It is also not clear from the consultation whether any adjustment would be made using the effective tax rate or the statutory rate, something that would have a significant impact.

(iv) Aggregate ODI cap and collar

Ofwat's proposed approach:

- Do not adjust ODI rewards and penalties for taxation comparison with cap

SWS view:

- Consistent with our response above, we do not support an adjustment to effectively increase the ODI cap.
- An adjustment of the type proposed would materially increase the ODI risk to which Southern Water is exposed, and on which basis we made our decisions on acceptance of the final determination.

(v) Scheme ODIs

Ofwat's proposed approach:

- We set out principles that will apply to the assessment of major scheme ODIs in PR19

SWS view:

- We believe that the principles set out in the consultation should, in most cases, provide an appropriate degree of certainty for companies.
- Where there are uncertainties over whether delivery meets the final determination requirement, we would expect that Ofwat would be willing to engage fully with companies at an appropriate time, when there is still the opportunity for companies to remedy any perceived shortfalls.

(vi) Asset Health ODIs

Ofwat's proposed approach:

- Require companies to publish further details for asset health measures where these are not included in PR14 final determinations

SWS view:

- Southern Water has two Asset Health ODIs. However, each sub-component of our Asset Health measures has clearly defined penalties for performance breaches. Thus, we do not believe that in our case any further clarification is necessary.
- We would expect that companies who have not defined their Asset Health ODIs so clearly would have included their method of assessment in their business plans, so these will already be in the public domain. If that is not the case then it is important that these are clearly defined.

B. Wholesale water and wastewater costs and revenues (Appendix 3)

Totex cost sharing

(i) Definition of totex for the purposes of menu sharing

Ofwat's proposed approach:

- Exclude items not included in the menu baseline such as third party costs, pension deficit recovery and transition costs

SWS view:

- We agree with the proposed treatment of third party costs and defined benefit pension scheme deficit contributions, which are consistent with our understanding of the basis of the menu.
- We agree that fines imposed under section 22a of the Water Industry Act 1991 or the Competition Act 1998 should be excluded. However, other fines incurred in the normal course of business (for example for pollution incidents) were included in the menu baseline historic costs and should not be excluded from the actuals. The definition of "investigation costs" also needs to be clarified. We assume the intention is to exclude any special regulatory fees associated with investigations under WIA91 or CA98, rather than a wider definition of investigations.
- We are not clear on the basis for the adjustment for legacy depreciation, which stems from the change in Ofwat's accounting rules during the PR14 process. The explanation of this suggests that "this depreciation was included in the final determination menu baseline", which is not correct. The baseline included operating expenditure and capital expenditure, but took no account of depreciation. The definition and explanation of any adjustment for legacy depreciation needs to be further considered. We are not currently convinced there is a case for any adjustment.
- The definition of "disallowables" is new to us. We agree with most of the items listed, but would question the final element, which is costs where Ofwat concluded ex-ante that there was no customer benefit. We take this to mean that any expenditure associated with a claim for a special cost cases that Ofwat did not allow in the final determination, should be excluded. This would appear to be a change in policy. Our understanding was that all expenditure should be included in the menu, to allow companies to make investments that customers support. This is the case with the capital incentive scheme and we expected this to be the case under the totex menu. Any adjustments of this type would potentially be subjective and we believe there is no case for such an adjustment.

(ii) Treatment of inflation in totex cost sharing

Ofwat's proposed approach:

- Deflate future year total expenditure using actual RPI for comparison for PR14 allowance

SWS view:

- We agree that using financial year average RPI to deflate actual expenditure to 2012-13 prices is appropriate. For the avoidance of doubt, it would be helpful to clarify that COPI will not be used within the true-up.

(iii) Allocation of totex out/under performance to RCV and revenue

Ofwat's proposed approach:

- Allocate out- and underperformance using weighted average PR14 PAYG rate, with companies providing robust evidence for changes that are in customers' interests

SWS view:

- We agree with the proposal to allocate out- and underperformance using weighted average PR14 PAYG rate. This is consistent with the assumptions that we have made in our own modelling.

(iv) Treatment of time value of money on totex sharing

Ofwat's proposed approach:

- Adjust for time value of money for customer sharing of out-/underperformance

SWS view:

- We agree that for totex an adjustment for the time value of money is appropriate, given its potential materiality.

(v) Treatment of taxation on totex sharing

Ofwat's proposed approach:

- Include a taxation adjustment for RCV changes only

SWS view:

- We agree with the proposal to include the tax adjustment only in respect of RCV adjustments.

WRFIM

(i) Treatment in WRFIM of revenue from in period ODIs

Ofwat's proposed approach:

- Exclude revenue changes from in-period ODIs from WRFIM reconciliation

SWS view:

- We do not have any in-period incentives. However, we agree that such payments should, in principle, be excluded from the WRFIM calculations.

(ii) Treatment of taxation in WRFIM

Ofwat's proposed approach:

- Do not include taxation adjustment in PR19

SWS view:

- We agree that a taxation adjustment for the WRFIM would not be appropriate.

(iii) Treatment of blind year

Ofwat's proposed approach:

- Include blind year adjustment in PR19

SWS view:

- We agree that an adjustment based on forecast outturn revenues would be appropriate and is consistent with the approach taken to the AMP5 Revenue Correction Mechanism.

Water trading incentives

(i) The export incentive

Ofwat's proposed approach:

- 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

SWS view:

- We agree with the proposed approach which is in line with that previously consulted on and set out in the methodology statement. We do not believe the other options presented are entirely consistent with previous Ofwat statements.

C. Reconciliation of PR09 incentives (Appendix 4)

(i) Indexation in the CIS RCV adjustment

Ofwat's proposed approach:

- 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.

SWS view:

- Our detailed comments on this aspect of the proposals are set out in our letter above.

(ii) Blind year reconciliation: use of materiality thresholds

Ofwat's proposed approach:

- Include a materiality threshold for the blind year adjustment.

SWS view:

- We do not support the new proposal to introduce a materiality threshold for the blind year adjustment. Such an adjustment would be retrospective in its effect, in that companies will have made decisions about investment on the basis that these mechanisms would be fully trued-up, in the same way as in the final determination.
- In our own case, as part of our ongoing investment prioritisation and optimisation process, we have invested additional capex in the wastewater service, but less in the water service, with a net overall increase in investment. Under Ofwat's proposals, the additional investment in the wastewater service would not be recognised, as it does not meet the threshold, but the reduction in water spend would be. This means that, although we would have invested more overall, we would face a RCV log-down.
- Our Board took decisions on the re-prioritisation of investment based on a clear understanding that all of the investment would be recognised in the true-up. This expectation would be undermined by the proposed materiality threshold.

(iii) COPI updates for the CIS model

Ofwat's proposed approach:

- Adjust for COPI when accurate data becomes available (for example, in 2016)

SWS view:

- We agree that we should wait until firm COPI data becomes available before updating for COPI. We do not think the use of forecasts or estimates is appropriate for a true-up that does not need to be made before 2019.

(iv) The treatment of PR09 reconciliation adjustments in the PR19 review

SWS view:

- We agree that the treatment of tax and the time value of money should be consistent with the approach taken for the PR09 reconciliation and PR14 adjustment.

D. Household retail (Appendix 5)

(i) Reconciliation of household retail control

Ofwat's proposed approach:
- Include a wash-up between allowed and outturn revenues in PR19

SWS view:
- We agree that a reconciliation between outturn revenues and those within the Final Determination at the end of the period is appropriate.

(ii) Treatment of time value of money

Ofwat's proposed approach:
- Do not adjust for the time value of money

SWS view:
- We agree with the headline proposal to not adjust for the time value of money, on the basis that this is very unlikely to be material and would add an unnecessary complication to the reconciliation.
- However, we note that Ofwat would consider a financing cost adjustment for material differences, but does not say what constitutes "material". We do not support this aspect of the proposals as it is this type of uncertainty that the rulebook is designed to remove. If there were significant variations in companies' revenues in-period, we would expect Ofwat to take prompt regulatory action at the appropriate time, to protect customers' interests.

(iii) Treatment of taxation

Ofwat's proposed approach:
- Do not adjust for taxation

SWS view:
- We agree that an adjustment for taxation is not necessary.