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Your ref:

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Sutton and East Surrey Water
150 years of quality on tap

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Dear Sir/Madam

Consultation on the PR14 Reconciliation Rulebook

Sutton and East Surrey Water welcomes the initiative taken by Ofwat to clarify the way in which methodologies put in place as part of the PR14 Price Review will be applied in practice at the end of the current period. The practical application of "reconciliation" mechanisms has always been an avoidable uncertainty at previous Price Reviews. This initiative to specify how the mechanisms will be applied at PR19 is a helpful way of improving regulatory transparency and certainty. Our comments on specific issues should therefore be set in the context of strong support for the principle objective of defining a "reconciliation rulebook" as an intrinsic part of completing any Price Review.

Our response follows the order of your consultation document.

Assessment Criteria
The consultation rightly starts by setting out the criteria to be adopted in testing alternative options for the various reconciliations needed. It does not however seek to consult on the criteria used. We consider this a serious omission. Whilst the criteria adopted must ultimately be consistent with Ofwat's statutory duties – and these are rightly considered the "primary criteria for assessing options" - there are material judgements required in applying statutory duties and these should be part of the consultation exercise. Otherwise options might be incorrectly narrowed down by applying challengeable interpretations of statutory duties.

The first criterion to be applied ought to be consistency with Final Determinations. The reconciliation rule book is effectively completing the Price Review by providing the detail on how mechanisms established as part of the Price Review will be operated in practice. Ideally, this detail should be available at the same time as Final Determinations are made, because when companies make decisions about whether or not to accept a Final Determination, they take into account how such mechanisms will affect them at the end of the period. Defining mechanisms in detail at the time that Final Determinations are published has never been achieved in the past – and the current initiative is welcome because it has the potential to bring forward such clarity. In the absence of certainty at the time that Final Determinations were published – and decisions to accept had to be made by companies - the clarifications now offered should be consistent with the reasonable expectations (of how mechanisms would operate) at the time that decisions on Final Determinations were made.

This is particularly important in the context of the proposed caveat on the criterion of consistency with Final Determination and other documents – "unless the inconsistency relates to a mistake in the published documents". This caveat has particular relevance to the proposed change in approach to the indexation of additions to the RCV through the PR09 CIS mechanism, but could arguably equally be applied to other aspects of Final Determination documents. Such "mistakes" - or interpretations which companies and other stakeholders might disagree with - needed to be considered in the round, as part of the overall package which had to be accepted or challenged. Changing parts of that package retrospectively and selectively is poor regulatory practice, and should be avoided.

We agree that avoiding any detriment to customers' interests and to company financeability are also primary assessment criteria, although these should be already have been addressed by ensuring consistency with Final Determinations (which had to meet these criteria anyway). We note and welcome the clear policy statement that PR19 financeability assessments will be carried out before taking account of PR14 reconciliation mechanisms.

We support the secondary assessment criteria proposed, but consider that reversing the order would be more logical (although the criteria do not appear to be applied sequentially so the impact may not be material). Thus being "straightforward and clear to implement" (criterion number 7) and "consistency with other reconciliation tools" (criterion number 6) will actually promote "company ownership and accountability" (criterion number 5) and help minimise the "risk of perverse incentives" (criterion number 4). Moreover, according greater weight to consistency in the application of regulatory mechanisms has the potential to simplify many common aspects of the reconciliation rulebook – which are consulted on specifically in the topic specific subsequent sections. For example, the presumption should be that all adjustments will

- Adjust for inflation using a common set of indices (lagged November to November RPI);
- Take into account the time value of money to remove perverse incentives to delay expenditure on delivering benefits to customers; and
- Take into account the impact of tax in the same way as was taken into account in PR14 Final Determinations (including using the same tax rates).

Unless commented on in relation to specific reconciliation requirements, we consider this approach should be applied consistently across all areas.

Outcomes

Our preferred approach to the first three consultation questions for this section is set out above.

The proposed approach to the operation of the aggregate cap and collar on financial ODIs is a departure from the position set out in Final Determinations and is clearly not consistent with the package that companies made their decisions upon.

The link between the values attributed to some rewards and penalties through companies' Willingness to Pay research and the operation of these subsequently-defined mechanisms is at best weak, and in some cases contradictory. This is unsatisfactory – although perhaps unavoidable given that customer research in many cases needed to be completed before regulatory mechanisms were defined. An improved linkage – through earlier definition of regulatory mechanisms – is clearly desirable for future Price Reviews.

We consider the proposed approach to assessment of Scheme ODIs highly unsatisfactory. The Final Determination for Sutton and East Surrey Water introduced a new ODI on water softening that had not been discussed with the Company, and was defined at best in an ambiguous manner in the Final Determination documents. The Company worked hard with Ofwat to agree a workable definition of the obligation – including agreement of a Scheme Deliverable as well as an overall asset health measure – and it was only on the basis of this understanding that the Board was able to accept the Final Determination. The proposed principles articulated in this consultation appear to provide the opportunity to re-open this agreement by providing that "in the case of inconsistencies, the Final Determination document takes precedence over any additional documentation" and setting "a high burden of proof to demonstrate delivery of the project". Whilst the Company is content to provide any evidence required to demonstrate delivery of the project specified in the additional documentation evidencing the basis upon which the Company accepted the Final Determination, it is not acceptable to reopen the agreement upon which the Company made decisions. Only where the Final Determination document was not subsequently formally clarified should the recourse be to the Final Determination document alone.

We support the principle of companies publishing additional information on the operation of ODIs to promote wider stakeholder understanding of how the mechanisms will operate and how a company's performance is assessed, and envisage our successor to the PR14 Customer Challenge Group having an particular interest in this information. We note the emphasis placed by the consultation on final determination documents taking precedence over any subsequent material published by companies in the case of any conflict of interpretation. To avoid any surprises in judgements exercised at PR19, we suggest that there should be mutual obligations for companies to share any published explanations or clarifications of ODIs with Ofwat, and for Ofwat to confirm that the explanation or clarification is consistent with their intended application of the incentive.

Wholesale Totex
We agree that adjustments to reported totex will need to be made to make it comparable to the menu baseline included in Final Determinations, and note the proposed adjustments, which appear reasonable. However, this is an area that will need to be kept under review as all reporting changes – such as that for recharges for shared assets referred to in the consultation – will need to be taken into account. To aid this approach, companies should highlight any changes that they consider relevant in their commentaries in their annual performance report, and Ofwat should address the need for additional adjustments when implementing new reporting requirements.

We agree that out/under performance of totex allowances should be allocated between RCV and revenue in the first instance by the average PAYG rate used for PR14 Final Determinations, with the option for companies to justify a different allocation if this was in customers' interests. In reality, the allocation of out/under performance will be only one of many elements contributing to company proposals on bill profiles and affordability at PR19 and is unlikely to be considered in isolation. The initial or default allocation of out/under-performance is therefore likely to be absorbed in these wider cost recovery proposals.

Wholesale Revenue Forecasting Incentive Mechanism (WRFIM)
We support the principle and intent of the WRFIM, with any necessary adjustments being made as part of PR19 Determinations.

We agree that any revenue adjustments arising from the operation of in period ODIs (for those companies that have them) need to be included in allowed revenues to ensure consistency of treatment across companies and to maintain the incentive properties of the WRFIM.

We also support the proposal not to include a tax adjustment on revenue changes arising under the WRFIM. Although this is not consistent with the treatment of tax in other reconciliation mechanisms, the resulting double-allowance for tax is clearly inappropriate and in this instance outweighs the value of maintaining consistency across reconciliation mechanisms.

We agree that the PR19 WRFIM adjustment should include an updated forecast of revenues for 2019-20 to ensure that the bulk of any variation from allowed revenues in this final year is taken into account in revenues for the 2020-25 period. Only the residual difference (between the forecast and actual revenue for 2019-20) is then left to be dealt with at subsequent Price Reviews.

Water Trading Incentives

We support the principle of seeking to incentivise water trading where it is beneficial to do so, and work closely with other members of the Water Resources in the South East Group to identify and develop opportunities for water trading in the resource constrained area we serve. The clarification published by Ofwat of the conditions that companies must include in their Trading and Procurement Codes, and the advice on additional principles and the approval process, are also helpful in encouraging proposals to be brought forward.

It is essential to provide an adequate incentive for an exporter to develop a new resource specifically for export, or give up an existing resource which provides security of supply to the company's existing customers. The proposed option ("Option 2b") offers an improvement on current incentives and is therefore welcomed. It is unclear, however, whether the incentive will be sufficient in the context of long-term (20 year plus) agreements, which need to be incentivised to make significant water trading a reality. A worked example of how the proposed allowance would be calculated at PR19 for a hypothetical 25 year agreement would be useful.

We remain unconvinced that there needs to be an import incentive: the principal requirement for an importer is that there should be no regulatory dis-incentive to adoption of a water trading option. An incentive to the importer appears to require the importer's customers to pay more than they would otherwise do under a simple application of the principles of an economic balance of supply and demand. Indeed an incentive might well encourage a company to seek an import rather than invest in demand management.

Reconciliation of PR09 Incentives

We strongly disagree with the proposal to correct the "mistake" in PR14 Final Determinations from 2020 onwards as part of the PR19 Review. We have argued that the reconciliation rulebook should simply be regarded as filling out detail of Final Determinations and the most important criterion is therefore that it is consistent with the principles adopted for Determinations. The argument that the treatment now proposed from 2020 onwards was not adopted for PR14 Final Determinations because it was a late change that risked creating regulatory uncertainty is not convincing as the issue had been trailed on a number of occasions leading up to PR14 and a methodology had been set after extensive consultation and reflection. It is therefore reasonable for companies to expect that the published methodology would be honoured going forwards – albeit that a different approach might be adopted for the indexation of new incentives (the totex under/out performance sharing mechanism). Moreover, Boards made decisions on whether to accept or challenge PR14 Final Determinations in good faith based on the material and methodologies extant at the time. Seeking to revise the published methodology after decisions have been made on the acceptability of Final Determinations in the round (including the treatment of CIS RCV adjustments at future Reviews) in itself creates regulatory uncertainty because it creates the spectre of other elements of published methodologies being dis-applied, or applied in a different manner, at future Reviews. The impact on customer bills can, of course, be addressed through the bill profiling and affordability mechanisms (PAYG and RCV run-off rates) introduced at PR14, in the same way that they can be deployed to address other pressures on customers' bills.

We consider that adjustments for the difference between 2014-15 actuals and the forecasts assumed in PR14 Final Determinations should be calculated and applied at PR19 in the same way that the adjustments were calculated and applied in PR14 Final Determinations (which had no materiality thresholds). Introducing materiality tests for this final set of adjustments is not consistent with the approach adopted in Final Determinations and serves no useful purpose as there is no time pressure to calculate the adjustments and they can easily be accommodated in the PR19 process. We agree that the initial calculations should be undertaken by companies and submitted to Ofwat during 2015.

We agree that the COPI update for the CIS model should be based on the updated index, whenever this becomes available. As the adjustment dos not need to be applied until PR19 Determinations, the risk of the update not being available by 2016 (as anticipated in Final Determinations) is not a significant concern.

Household Retail
We do not understand the need for a reconciliation of household retail revenues. Actual revenues will be based on the number (and mix) of households actually billed each year – and the fact that there may be a difference between the number of households forecast to be billed at the time that charges are set for the coming charging year and the number billed during the year seems irrelevant. Provided household retail charges properly reflect the allowed revenue per customer, the variation in revenue will arise from the operation of the revenue modification factors set out in Final Determinations. The focus therefore moves from assurance on actual household retail revenue to allowed revenue per customer – which forms part of the charges assurance process (including assurance by an external auditor). Clarification of the issue trying to be addressed by this part of the reconciliation rulebook would therefore be appreciated.

Other Issues
We note and support the continued approach to the treatment of qualifying land sales first adopted at PR94 and operated successfully ever since.

We have noted the need to consider the application of our Company-specific gain sharing mechanism in the context of the industry-wide mechanisms included in PR14 Final Determinations, and welcome the offer by Ofwat to engage constructively with us as we work through implementation plans as opportunities arise.

Concluding Remarks
The initiative taken by Ofwat to set out the rules to be applied in implementing the mechanisms established by PR14 Final Determinations has highlighted a number of substantive issues, reinforcing the value of seeking to provide early clarity on the procedures to be adopted in the future. We support many of the approaches proposed, but have material concerns about a lesser number of them. The real achievement of this consultation is to expose the areas of disagreement now, enabling decisions to be made in an informed and timely manner. As always, we would be more than happy to amplify or debate any aspects of our response at your convenience.

Yours faithfully

John Chadwick
Finance and Regulation Director