Ofwat's consultation on the PR14 reconciliation rulebook

Consumer Council for Water Response **May 2015**

1. Introduction

1.1 The Consumer Council for Water (CCWater) is the statutory consumer organisation representing water and sewerage consumers in England and Wales. CCWater has four regional committees in England and a committee for Wales.

1.2 We welcome the opportunity to comment on Ofwat's consultation on the proposed reconciliation rulebook from the 2014 price review (PR14). This has a potentially significant customer impact because how Ofwat takes account of company performance against regulatory incentives set for 2015-20 will potentially affect customers' bills from 2020-25.

2. Executive Summary

2.1 We welcome Ofwat's intention to be fully transparent about how it will reconcile the differences between cost forecasts at PR14, and actual costs incurred during 2015-20.

2.2 It is helpful that Ofwat has considered both totex <u>and</u> incentive reconciliation issues early in this price control period. This should reduce the risk of companies not acting in customers' interests by making incorrect assumptions about how PR14 reconciliations will be applied at PR19.

<u>Outcome Delivery Incentives (ODIs)</u>

2.3 Part of the range of adjustments Ofwat proposes includes the application of rewards and penalties resulting from ODIs. While we understand the regulatory rationale for these incentives, there is a risk of a negative customer reaction if the payment of ODI rewards is seen to drive future bill increases, along with inflation[1].

2.4 We recognise that the 'real term' level of reward and penalties for ODIs that apply at the end of the price control period may be subject to adjustments, either at the end of the period or (for a small number of ODIs) 'in period'. However, any adjustments that potentially increase the level of reward could aggravate customers' negative perception further, particularly if such adjustments are inconsistent with the 'cap and collar' boundaries for ODIs.

<u>Wholesale Totex</u>

2.5 We agree with Ofwat's proposed adjustments for under or out performance in terms of actual totex, through mechanisms to adjust financial performance in line with RPI and the 'time value' of money. This will help ensure that companies deliver their PR14 commitments to customers, without being inadvertently incentivised to make savings earlier in the period and possibly delay the delivery of such commitments as a result.

2.6 We also agree that the customer share of any totex out or under performance should be applied in line with the RCV/pay as you go' ratios set in the Final Determinations.

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[1] Our earlier PR14 submissions to Ofwat highlight evidence that shows that customers do not support the principle of applying financial rewards to drive service improvements, Please see ' Outcome Delivery Incentives in the Water Industry (SPA Research for CCWater, March 2014)' http://www.ccwater.org.uk/wp-content/uploads/2014/03/Outcome-and-Delivery-Incentives-Report-FINAL.pdf

2.7 Any adjustments to sharing totex outperformance with an allowance for tax would need to be explained to customers. There is a risk that customers may be given the impression that a company that has outperformed has been rewarded twice with an additional allowance given to accommodate tax. Recent years have shown that water companies' tax payments and allowances have been an issue to customers, so an explanation of what benefits have been provided to customers in this scenario would be helpful.

Other incentive mechanisms and adjustments

2.8 We broadly agree with Ofwat's proposed actions in terms of adjusting the incentives for wholesale revenue forecasting, water trading, the reconciliation of PR09 incentives and household retail.

2.9 However, we would welcome further clarity and consultation from Ofwat on;

- What constitutes a 'material' impact on customers, to justify an adjustment to accommodate the differences between forecast and actual household retail costs.
- How Ofwat and companies should estimate costs in 'blind years' (such as 2019-20) when actual costs will not be known in time for Ofwat's PR19 determinations.
- The principle and/or guidance Ofwat will develop for consistency in measuring performance on asset heath and major scheme ODIs.

2 Comments on Ofwat's proposed approach to PR09 and PR14 reconciliation

The following tables provide comments on the proposed approaches to reconciliation across the value chain, and future reconciliation due to indexation adjustments in 2010-15 relating to the PR09 Capital Incentive Scheme (CIS).

Table 1: Outcome Delivery Incentives (ODIs)

	Ofwat proposal	CCWater comment
1	Ofwat proposes using actual average year RPI to inflate PR14 values to PR19. For companies that have ODIs that may trigger 'in period' revenue adjustments (Anglian, Severn Trent, South West), Ofwat proposes to apply the preceding November's RPI for any wholesale ODI rewards or penalties that will be applied to the following year's revenue allowance.	**We can see Ofwat's rationale,** as the Ofwat FD set ODI rewards and penalties in the 2012-13 price base with no adjustment for future inflation that affects future costs. However, our concern about the possible customer negative reaction to ODI rewards remains. Applying the preceding November's RPI for 'in period' ODIs is consistent with how RPI is applied to each year's wholesale K. The allowance for RPI should be accommodated within the financial boundary for ODIs (+/- 2% of the regulated return on equity), as this is the parameters for the customer bill impact of ODIs. The other options Ofwat put forward (such as using forecast RPI) are more complex, and may lead to further adjustments at the following

		price review, which (along with other 'legacy' adjustments applied at a price review) could mean a higher level of uncertainty in terms of the customer bill impact.
2	For ODIs that are evaluated and applied at the end of the price control period, Ofwat propose not adjusting the 'time value' of the reward or penalty to accommodate any difference in the value of the incentives between when it is incurred and when it is received.	**We agree.** We question whether an adjustment to accommodate the timing difference between when money is paid out (or received) and when it is reimbursed is applicable for ODIs. This is because the majority of companies have chosen to accept changes to revenue and the RCV caused by ODIs at the following price review, within the financial boundaries (+/- 2% on regulatory return on equity) set out in the FDs.
3	Ofwat proposes to apply a tax allowance to ODI rewards and penalties (e.g. if a company has a tax margin of 20%, a £1m reward pre-tax, would be £1.2m when a tax adjustment is applied)	**We are concerned that such an adjustment may lead to a negative perception from customers.** While we understand the regulatory rationale for ODIs, as the Executive Summary highlights, there is evidence that customers have a negative perception of potential rewards for service delivery. This could be aggravated further if companies receive an additional allowance on their reward to accommodate tax. In this case, if rewards are achieved, customers need to receive an explanation of the value of the benefits they are receiving in return for companies being given such a reward with a tax adjustment added.
4	Ofwat propose not adjusting the aggregate cap and collar of ODIs (+/- 2% of notional regulated equity) to take into account tax incurred in period.	**We agree**, as such an allowance would move away from the parameters of customer bill impact of aggregated ODIs as implied by the cap and collar.
5	Where companies have ODIs relating to the delivery of specific major schemes, Ofwat propose developing principles on how companies should report on progress, to evaluate whether a reward or penalty applies.	**We agree**. It is important that there is transparency and consistency on reporting progress of the delivery of such schemes, the costs incurred, and the performance of the scheme when completed. This is particularly important if customers have to pay a reward for its successful delivery. However, companies should be fully responsible for both delivering these schemes and reporting to Ofwat and customers alike on progress with delivery. We look forward to Ofwat consulting further on this.

6	ODIs relating to 'asset health' (as used by a number of companies) assessed using a basket of measures, with a formula applied to avoid the risk of companies placing an inappropriate weight on some measures.	**We agree.** Rewards for asset health and performance should be looked at in the round to see how overall reliability and resilience has been delivered for customers. We look forward to further consultation on how such a framework will work.

Table 2: Wholesale Totex

	Ofwat proposal	CCWater comment
1	Ofwat proposes excluding a number of third party costs (e.g. pension deficit recovery costs) from its definition of totex for the purpose of evaluating actual costs compared to assumed costs.	**We agree**, as making allowances for third party costs so they are recovered from customers will remove any company incentive to manage such costs effectively.
2	The customer share of any totex out or under performance will be applied to either revenue or the RCV at PR19 in line with an individual weighted average PAYG over the five years, as set in the Ofwat FD.	**We agree** as this is reflective of the weighted average PAYG ratio set in the FD, which in some cases, was influenced by customer research on the balance between current and future customers.
3	Totex out and under performance will be adjusted at the end of the period to take into account actual RPI, as there is no allowance for this in the 2012-13 price base used in the Ofwat FDs.	**We agree.** The totex set in the 2012-13 price base will be uprated to reflect the impact of actual RPI, when companies' actual totex is assessed at PR19.
4	Totex out and under performance will be adjusted at the end of the period to take into account the difference in the value of money between when the out or under performance occurred, and when it is shared at the following price review.	**We agree** because if this is not adjusted companies may be inadvertently incentivised to make savings earlier in the period to obtain a saving of greater value compared to a saving that's achieved later. This could delay the delivery of required capex to deliver customer outcomes.
5	Ofwat will adjust the level of totex under/out performance at PR19 to account for tax, but only on the customer	**There is a risk of a negative customer reaction to such a tax adjustment.** We understand that Ofwat does not wish to

	share on the totex under/out performance applied to the RCV.	risk undermining the strength of the incentive for companies to be cost efficient, but there is a risk of a negative customer perception if companies are seen to achieve a share of totex outperformance with a further allowance added to accommodate tax. Water companies' tax arrangements have been an issue for customers in recent years. As per our comments on tax adjustments under ODIs, customers need to be informed of the value of the benefits they are receiving in return for companies having a share of outperformance with a tax adjustment added.

Table 3: Wholesale Revenue Forecasting Incentive Mechanism (WRFIM)

	Ofwat proposal	CCWater comment
1	Include the revenue impact of 'in period' ODI rewards and penalties in the assessment of actual revenue compared to forecast revenue.	**We agree** because if a company with 'in period' ODIs has put forward a wholesale revenue forecast that includes ODI rewards, it will need to achieve or exceed the ODI target to avoid getting a penalty under the WRFIM. This could act as an extra incentive to deliver the ODI target to benefit customers.
2	Ofwat propose not to apply a tax adjustment on revenue changes when assessing actual revenue with forecast revenue in the WRFIM.	**We agree** as Ofwat's analysis shows how adjusting for tax could lead to a double allowance for companies.
3	Ofwat would like to apply an adjustment to its assessment of actual vs. forecast revenue (if applicable) at PR19 for the 'blind year' of 2019-20, based on an estimate – adjusting further at PR24 once actual revenue for 2019-20 is known.	**We agree in principle**, but would suggest that Ofwat consult further with the industry on the estimation techniques they intend to use. It would be in everyone's interest to minimise the level of subsequent adjustments.

Table 4 – Water Trading Incentives

	Ofwat proposal	CCWater comment
1	If an exporting company has achieved a reward, the payment to that company at PR19 will be equal to 50% of the profit for the forecast life	**We agree** as allowing an incentive based on forecast profit beyond 2015-20 would lead to customers paying for an incentive where actual profit on a water export has yet to be achieved. Not paying an incentive until the

	of the export, capped at the level of profit achieved in the 2015-20 period.	end of the life of the export (which could be many years) may reduce the effectiveness of the incentive to encourage more water trading.
2	When calculating the export incentive payment, Ofwat will adjust to take into account inflation and the time value of money.	**We agree** that export incentives should be adjusted to reflect inflation and 'time value' differences. We have supported water trading as bulk supply exports can be a lower cost and more sustainable method of securing future supplies for customers. As they are long term arrangements, it is reasonable that incentive levels reflect cost changes caused by 'time values' and inflation, to ensure the trading incentive remains strong.

<u>Table 5- Reconciliation of PR09 incentives</u>

	Ofwat proposal	CCWater comment
1	Ofwat has responded to representations from companies highlighting inconsistency between the forecast inflation indexed to RCV adjustment and financing costs under the Capital Incentive Scheme (CIS) from PR09, and actual outturn RPI. To resolve this, Ofwat proposes to make an adjustment at the end of the current price control period to adjust the RCV at PR19, using actual (outturn) RPI of the 2010-15 period.	**We agree** and note that the adjustment proposed should see the regulated capital value of water companies falling by around 2% from 2020, though this may be offset by other potential incentive rewards (ODIs, totex cost sharing) that are applied to the RCV at PR19. In the interests of maintaining stability in the sector, which benefits customers, the RCV should be an accurate reflection of the value of a company, so we accept Ofwat's proposed reconciliation.
2	For the 'blind year' of 2014-15, Ofwat proposes making an adjustment at PR19 for incentive mechanisms such as CIS and the Revenue Correction Mechanism, only where actual revenue exceeds a materiality threshold of +/-2% of turnover.	**We agree** as this ensures that all adjustments are considered in the round and only applied if there is a material impact on the company and/or customers.

Table 6 – Household Retail

	Ofwat proposal	CCWater comment
1	Ofwat wants to reconcile forecast retail revenue and actual revenue at PR19. The number of actual retail customers compared to the PR14 forecast will be a key component of this.	**We agree** as allowing 'in period' adjustments could reduce the company's incentive to manage retail revenue efficiently over the five years, to the benefit of customers.
2	Ofwat do not propose to reconcile forecast and actual retail revenue by taking into account the 'time value' of money (the difference between the value of money when it's received, and when it is remunerated at PR19) or taxation.	**We agree in principle** because Ofwat's analysis shows that the material impact of 'time values' and tax would be small, and the Ofwat FD says that adjustments would only be allowed if the difference between forecast and actual revenue is 'material'. However, the consultation does not define what constitutes 'material' in terms of household retail and we would welcome further clarification on this.

Enquiries

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