

# *PR14 Reconciliation Rulebook*

*Updated recommendations  
for implementing PR14  
reconciliation mechanisms*

*Ofwat*

*July 2015*



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# Contents

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<b>Section 1. Executive summary</b>	<b>4</b>
<b>1.1. Summary</b>	<b>5</b>
<b>Section 2. Updated recommendations</b>	<b>8</b>
<b>2.1. Outcome delivery incentives</b>	<b>9</b>
<b>2.2. Totex incentives</b>	<b>17</b>
<b>2.3 Wholesale Revenue Forecasting Incentive Mechanism</b>	<b>24</b>
<b>2.4 Reconciliation of PR09 incentives</b>	<b>30</b>
<b>2.5 Household retail</b>	<b>35</b>

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# *Section 1. Executive summary*

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## 1.1. Summary

**This document updates our recommendations to Ofwat on the way the incentive mechanisms which formed part of the 2014 Price Review (PR14) should be reconciled at the next price control review (PR19), in the light of the responses to Ofwat’s consultation on the PR14 reconciliation rulebook.**

### *Background and context*

In March 2015, Ofwat published a draft reconciliation rulebook (RRB) which set out its proposals for the way that the new PR14 incentive mechanisms will be reconciled at PR19, and the approach to reconciling the final position for the incentive mechanisms established at PR09. Alongside the RRB, Ofwat also published spreadsheets which illustrated the approach to each reconciliation mechanism, and our report which made recommendations on key policy areas.

Ofwat invited views from customers, companies and wider stakeholders on these RRB documents. Ofwat received responses from eighteen companies, the Consumer Council for Water (CCWater), the Environment Agency, and one member of the public:

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<b>Respondent</b>		
Affinity Water	Dŵr Cymru	South Staffordshire and Cambridge Water
Anglian Water Services	Environment Agency	South West Water
Bailock (private individual) <sup>1</sup>	Northumbrian Water	Sutton and East Surrey Water
Bournemouth Water	Portsmouth Water	Thames Water
Bristol Water	Severn Trent Water	United Utilities
Consumer Council for Water	South East Water	Wessex Water Services Ltd.
Dee Valley Water	Southern Water	Yorkshire Water

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As part of its approach to finalising the RRB, Ofwat asked us to consider the consultation responses and finalise our recommendations on how the mechanisms should be implemented. We have considered the consultation responses and, where appropriate, have updated our recommendations in light of the views, evidence and alternative proposals put forward by respondents. In doing so, we have followed a framework agreed with Ofwat.

In general, respondents welcomed the introduction of the reconciliation rulebook, noting that it provided greater clarity on the application of regulatory incentives at the beginning of the price control period. Most respondents agreed with the majority of the proposals in the draft RRB. However, there were also some areas of policy where some respondents disagreed with the proposed approach. The area of greatest disagreement was in relation to the reconciliation of the PR09 CIS at PR19, where the consultation sought responses on whether RCVs should be adjusted at PR19 to take account of an inconsistency in the application of indexation within the CIS model. Most companies considered that the proposed approach was a departure from Ofwat’s published approach and risked creating regulatory uncertainty. If an RCV adjustment is made at PR19, our view is that the calculation set out in the draft RRB and illustrative spreadsheet provides an appropriate approach<sup>2</sup>.

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<sup>1</sup> Our report does not directly address the comments made in this submission, which are a matter for Ofwat to consider.

<sup>2</sup> Subject to a modification in the run-off rate applied for Thames Water (to exclude run-off on the Thames Tideway Tunnel).

Overall, we recommend that Ofwat consider updating its proposed approach to implementing a number of the reconciliation mechanisms. We also recommend that Ofwat provides further information or guidance to support four of the reconciliation mechanisms, as well as a range of technical updates to the spreadsheets which illustrate how the mechanisms are calculated. Specifically, we have proposed a change in one of the following circumstances:

1. Where there was an error in the proposed approach;
2. Where respondents to the consultation have highlighted new evidence which changes our view of the appropriate approach; or
3. Where one or more respondents have proposed a better approach than the preferred option set out in the RRB consultation, having regard to the framework for assessing options as set out in Ofwat’s consultation.

For category 1, we note that where respondents have identified an error or mistake, these generally relate to technical errors in the implementation of the mechanisms in the rulebook documentation or illustrative spreadsheets, rather than mistakes within the proposed policy. Where this is the case, our recommendations focus on updating the supporting documentation rather than changing the underlying approach.

For category 3, we consider that the alternative approach must be consistent with the assessment framework set out in Ofwat’s consultation. That is; it must meet the three primary assessment criteria (1. customer benefits, 2. financeability, and 3. long-term customer benefits through consistency with final determination and other relevant documents), and provide a better balance across the four other assessment criteria (4. risk or perverse incentives, 5. company ownership and accountability, 6. consistency with other reconciliation tools, and 7. straightforward and clear to implement).

There are also areas where our original recommendations remain finely balanced following our assessment of responses. In these areas, we consider there is more than one credible option and Ofwat may wish to consider the strength of views expressed by respondents when finalising the position. In all areas, our recommendations are set out for Ofwat’s consideration - all final policy and implementation decisions are a matter for Ofwat.

## Summary of recommendations

**We recommend Ofwat considers changing the approach** (relative to the approach included in the draft rulebook) in the areas outlined in the table below:

Ofwat consultation proposal	Our recommendation
<b>Wholesale revenue forecasting incentive mechanism</b>	
Application of the WRFIM formula – Licence constraints	Ofwat should consider whether companies’ licences prevent them from deliberately over-recovering revenue from customers during the period. This could hamper their ability to respond to the WRFIM incentives. Depending on the legal constraints of companies’ licences, Ofwat could either adjust the WRFIM formula or consult on licence changes to allow companies to smooth revenue variances within the price control period.
<b>Reconciliation of PRO9 incentives</b>	
A4.3 Blind year reconciliation: use of materiality thresholds - Materiality threshold in aggregate	Ofwat should consider amending the materiality threshold for the AMP5 blind year reconciliation. Ofwat could either remove the threshold entirely (i.e. Option 1 as set out in the RRB consultation) or reduce the threshold to a trivial level. Evidence provided by the consultation responses suggests that a materiality threshold would not be strictly consistent with approach taken for the first four years of the PRO9 incentive mechanisms and indicates that the Final Determination did not create an expectation that Ofwat would use a materiality threshold.

We recommend Ofwat provides further information or guidance (but not change the underlying approach) in the following areas:

Ofwat consultation proposal	Further information required
<b>ODI incentives</b>	
A2.5 Aggregate cap and collar – Do not adjust ODI rewards and penalties for taxation to apply cap and collar	We recommend that Ofwat makes clear in the rulebook that the calculation and aggregation of penalties/rewards is the default calculation, and may be different for companies where their Final Determination require a bespoke aggregation calculation.
<b>Totex incentives</b>	
A3.2.1 Definition of totex for the purposes of menu sharing	Further detail is required on the definition of fines and investigation costs, legacy depreciation and “costs with no customer benefit”. The definition of “pension cash contributions” should be clarified in the rulebook.
<b>WRFIM</b>	
Additional relevant issues <sup>3</sup> - WRFIM definitions	It would be helpful for the RRB to explain the mapping between WRFIM inputs and the relevant RAG pro-forma
Additional relevant issues – WRFIM exceptions	We recommend providing further clarity over whether companies can request additional revenue for new connections.
<b>Reconciliation of PRO9 incentives</b>	
A4.2 Indexation of the CIS RCV adjustment – Adjust the RCV in PR19 to remove the balance relating to the use of different indexation approaches	Ofwat may want to consider providing further explanation around the original issue and why they consider an adjustment is necessary going forward. Ofwat may also want to consider further the impact of the adjustment on the shadow RCV and company financeability.
<b>Household retail</b>	
A5.3 Treatment of time value of money – Financing cost adjustment where material adjustment	We recommend Ofwat provides further details on the materiality threshold that will be used to determine whether a time value of money adjustment is required.

In the remaining areas, we do not consider that it is necessary to change the approach outlined in Ofwat’s consultation document. However, in some areas our recommendation is finely balanced and Ofwat *could* consider a change in approach; these areas are explained in section 2.

Additionally, we recommend that Ofwat updates the technical implementation of the mechanisms within the illustrative spreadsheets in a number of areas (for example, to correct errors or provide further clarity within the illustrative spreadsheets). The illustrative spreadsheets will reflect Ofwat’s final position on the reconciliation mechanisms.

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<sup>3</sup> “Additional relevant issues” refers to comments received on issues outside those specifically highlighted within Ofwat’s consultation document.

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## *Section 2. Updated recommendations*

# 2.1. Outcome delivery incentives

The table below summarises the consultation responses on Outcome delivery incentives and outlines our recommendations following consideration of these responses<sup>4</sup>.

Ofwat consultation proposal	Consultation response	Recommendation
<p><b>A2.2 Indexation – Use lagged Nov-Nov RPI to inflate PR14 values for in-period ODIs</b></p>	<p>All (fifteen) respondents who commented on this issue supported the proposal to use actual year average RPI to index PR14 values to PR19 values, and to use lagged Nov-Nov RPI to index values for in-period ODIs. We note that:</p> <ul style="list-style-type: none"> <li>• Bristol Water, whilst supporting the proposed approach, suggested a ‘true-up’ at the end of the period.</li> <li>• The Consumer Council for Water stated that it could see the rationale for the proposal but highlighted a general concern about possible negative customer reaction to ODI rewards, and highlighted that the allowance for RPI should be accommodated within the financial boundary for ODIs (i.e. the total value of the ODI reward/penalty).</li> </ul>	<p><b>No change required:</b> Although Bristol Water suggest a new option which would require a secondary reconciliation at PR19 to account the difference between Nov-Nov RPI and year average RPI for a small number of incentives for the three companies with in-period ODIs. While we agree this could be implemented, we remain of the view that the proposed option is more straightforward, easy to apply and is not likely to yield results which are materially different to year average RPI.</p>

<sup>4</sup> Where relevant, in this and the following sections we have included a reference to the relevant section of the Ofwat RRB consultation document. Further detail on each aspect of the Ofwat consultation proposal is available in our March 2015 recommendation document.

## Ofwat consultation proposal

## Consultation response

## Recommendation

### **A2.3 Time value of money – Do not adjust for time value of money**

Nine respondents supported the proposal to *not* adjust ODIs for the time value of money. These respondents agreed that it is a simple, practical approach and it is consistent with their understanding of ODI rewards and penalties.

Five respondents (Northumbrian Water, Bournemouth Water, Sutton and East Surrey Water, Severn Trent Water and South East Water) did not agree with this proposal. Some challenged the approach because it would risk creating perverse incentives and a lack of consistency between in-period and end-of-period ODIs (because some companies will receive rewards/penalties sooner). South East Water recognised that there may be practical constraints on determining the precise timing of rewards/penalties, but suggested a principle of consistency should be followed across the various adjustment mechanisms.

**No change required:** We note the comments made by respondents who prefer Option 2 (adjust for time value of money) and agree that it would provide NPV neutrality and consistency between in-period and end-of-period ODIs, had the ODIs been specified on a consistent basis.

However, we remain of the view that it would be complex to implement because it is difficult to identify the time at which some ODIs 'crystallise'. And, compared with other types of reconciliations, there is no clear requirement to adjust for the time value of money because (a) policy documents did not create an expectation that an adjustment of this type would be made, and (b) rewards/penalties do not necessarily reimburse companies for cost actually incurred over time.

## Ofwat consultation proposal

## Consultation response

## Recommendation

### A2.4 Taxation – Allow taxation on ODI rewards and penalties as part of PR19 review

Eight respondents supported the proposal to provide a tax allowance for all ODIs (Option 2). Five respondents (United Utilities, Thames Water, Bristol Water, Consumer Council for Water and Southern Water) disagreed with the proposal.

In particular, we highlight that:

- Bournemouth Water commented that whilst they agree in principle with Option 2, the consultation does not comment on the proposed tax rate. In this context, South East Water emphasised that the marginal tax rate of 20% should be used. They suggested the final rulebook should state the applicable rate for transparency purposes.
- Portsmouth Water and Thames Water confirmed that they did not explicitly account for tax as part of their WTP studies. However, Thames Water stated that customers' willingness to pay must implicitly include the tax impact on revenues.
- United Utilities indicated that the drawbacks acknowledged in the Ofwat consultation document significantly outweigh the potential benefits.
- Similarly, Thames Water and Bristol Water indicated that they did not believe that it is in their customers' interests to increase the impact on revenues above their customers' willingness to pay level by the addition of the further tax impact and suggested a preference for Option 4 (adjust ODIs rewards and penalties in PR19 to offset tax adjustment).
- Consumer Council for Water was concerned that the adjustment may lead to a negative perception from customers of potential rewards for service delivery.
- Southern Water did not agree with the proposed options and noted that the Final Determination did not raise the prospect of a further increase in what for them are very considerable penalties.
- Severn Trent Water agreed that all the proposed options have drawbacks, as outlined in the consultation document. They also agreed that the treatment should be consistent regardless of when any adjustment takes place (either in period or PR19) and how the ODI is applied (Revenue or RCV). Severn Trent Water considers that any adjustment should be in line with the treatment in financial modelling at PR19.
- Northumbrian Water stated that in their view the proposed approach is the most straightforward and consistent way of allowing taxation on ODI rewards and penalties and stated that under the proposed approach any links to willingness to pay are not materially undermined.

**Finely balanced recommendation - no change required:** As outlined in the consultation document, all options in this area have some drawbacks because ODIs are not clearly specified as either pre-tax or post-tax incentives. Our recommendation in this area is therefore finely balanced.

Respondents had mixed views on this issue and generally did not provide new evidence that had not been considered as part of the assessment of the options for consultation. Some companies confirmed that they had not accounted for tax as part of their WTP studies but it is not clear that all companies have constructed their incentives in the same manner (and indeed not all incentive rates are based on WTP). This drawback was identified in our original assessment of this option. However, Ofwat may wish to consider the issue further in light of company responses.

In future, Ofwat could establish a common basis for calibrating incentives as either post-tax or pre-tax, including the basis for conducting WTP studies.

## Ofwat consultation proposal

## Consultation response

## Recommendation

### A2.5 Aggregate cap and collar - Do not adjust ODI rewards and penalties for taxation to apply cap and collar

Eight respondents supported the proposal for Option 1 to not adjust rewards and penalties for taxation in the application of cap and collar.

Four respondents (Southern Water, Sutton and East Surrey Water, Bristol Water and United Utilities) disagreed with the proposal. We note that:

- Bournemouth Water stated that they were unclear about this proposal, but agreed that there should be consistency in methodology across the rulebook and accepted that the proposal is an appropriate approach.
- Two companies, Sutton and East Surrey Water and Portsmouth Water, considered the proposal to be a departure from the position set out in the Final Determination. However, Portsmouth Water stated that, from a customer point of view, explaining changes in bills as a consequence of rewards and penalties is difficult and a pragmatic cap of 2% appears sensible.
- Bristol Water and United Utilities recommended the adoption of Option 2 (adjust ODI rewards and penalties for tax) as they considered this to be consistent with the approach detailed within policy chapter A2 in the PR14 Final Determination and their preferred option on taxation. Bristol Water also indicated this is option is preferable to ensure consistency of tax treatment across different elements of ODIs.
- Two companies highlighted that it is unclear how the model addresses bespoke incentive structures. Dŵr Cymru welcomed the introduction of a cap and collar but noted that it is unclear how the model will deal with specific ODI interactions (e.g. ODIs which operate net of compensation already paid to customers). United Utilities also observed that the calculation of aggregate ODI rewards and penalties in the model does not reflect the way their proposed incentives are structured, as their penalties and rewards can impact upon either revenue or RCV depending upon whether the net position of all ODIs in total results in a penalty or a reward.
- Severn Trent noted that the tax treatment under this Option will mean that the cap/collar is less than the published P10/P90 values, as these were calculated under a different assumption for tax. However, it did not consider that this is a material issue as these figures were only illustrative.

**Finely balanced recommendation – no change in approach, but further information or guidance required:** This issue should follow the approach to A2.4 (ODI taxation).

As noted in the consultation document, if Ofwat adopts Option 4 for ODI taxation (as outlined above), it would be appropriate to revert to Option 2 for the aggregate cap and collar.

The ODI spreadsheet examples were prepared on an illustrative basis and do not cover all eventualities. As noted in the rulebook, the illustrative spreadsheet includes the option to model a bespoke ODI, which can be used to calculate ODIs that do not fit with the template examples. In addition, the rulebook recognised that there could be a small number of ODIs for which ad hoc modelling may be required at PR19.

We suggest that Ofwat makes clear in the rulebook that the application of the cap and collar does not allow netting off between aggregate rewards and penalties, but that the calculation of aggregate rewards and penalties may be different for companies where their Final Determination requires a bespoke approach.

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## **A2.6 Scheme ODIs - We set out principles that will apply to the assessment of major scheme ODIs in PR19**

Twelve respondents supported Option 2, which involves setting principles that will apply to the assessment of major scheme ODIs in PR19. Two respondents (Sutton and East Surrey Water and Severn Trent Water) disagreed with the proposal. In particular they expressed concerns about the proposed principles highlighted in the consultation document. We note that:

- Anglian Water, whilst agreeing with the proposed approach, suggested that Ofwat should commit to providing annual feedback on companies' annual reports submissions, verifying satisfactory delivery and articulating concerns about non-delivery. Anglian Water also suggested that it would be useful if Ofwat provided the calculations used when applying scheme delivery penalties to avoid the risk of duplicating adjustments already been made in the totex mechanism.
- Bournemouth Water agreed with the proposed approach but stated that they would welcome further definition of the proposed principles (e.g. what a "high burden of proof" to demonstrate delivery of a project will entail). Sutton and East Surrey Water considered the proposed approach to be highly unsatisfactory. They stated that they have worked with Ofwat to agree a workable definition of the ODI obligation set out in the Final Determination and highlighted that the proposed principles of Option 2 appear to re-open this agreement.
- Severn Trent Water considered the Final Determination to be too high level to "take precedence" over other documentation. They provided the example of the Birmingham Resilience Scheme which, when contrasted with the Final Determination summarisation, contains appendices which details an explanation of the ODI measurement. Severn Trent Water would also like Ofwat to clarify its role in the assurance of companies' scheme delivery reports as it is not clear to whom proof needs to be provided. Severn Trent Water considered Option 3 (where Ofwat engages directly with companies) to be a better option as the requirement to be consistent with the Final Determination would still apply.
- Bristol Water suggested that Ofwat could use the judgement of Customer Challenge Groups and independent assurers as the basis for a risk-based review at PR19.

The Environment Agency suggested that Ofwat should carry out an interim review of progress in 2017-18. They also indicated that if there is inconsistency between major scheme ODI completion dates in the Final Determination and the National Environment Programme (NEP), they expected the requirements of the NEP to take precedence. The Environment Agency also agreed that there could be cases where water companies deliver the outcomes related to a scheme by finding an alternative, more innovative solution, as long as these solutions provide the same benefits to the environment and customers and are consistent with the relevant NEP guidance.

**No change required:** We remain of the view that the proposed approach strikes the right balance between providing clarity, whilst retaining appropriate flexibility.

We do not consider that this option re-opens the Final Determination, but rather provides further clarity on how Ofwat will assess whether companies have delivered the required outcomes, consistent with the spirit of the Final Determination.

We suggest that Ofwat provides more clarity in the RRB about the relationship between the totex reconciliation and major scheme ODIs; we understand that totex is reconciled at an aggregate level rather than for specific schemes. Separately, Ofwat may want to consider the merits of providing feedback on companies' annual reports and of providing additional definition at this stage (e.g. on burden of proof or on the proposed principles).

We note the suggestion from the Environment Agency of an interim review of major scheme ODIs in 2017-18. This was already considered by Ofwat as part of Option 4 in the RRB consultation. However, Option 2 was seen as preferable as it maintains stronger company ownership for the delivery of schemes and the burden of proof that the scheme ODIs have been delivered, and it is more straightforward and clearer to implement. We remain of the view that this assessment still holds.

We understand that a number of the major scheme ODIs have been developed taking into account the relevant NEP requirements. Companies should comply with their obligations under the NEP. However, we do not consider that for the purposes of reconciling ODIs, the timing of NEP requirements should necessarily take priority over the delivery dates set out in the Final Determinations. Individual

Ofwat consultation proposal	Consultation response	Recommendation
<p><b>2.7 Asset health ODIs - Require companies to publish further details for asset health measures where these are not included in PR14 Final Determination</b></p>	<p>Most respondents supported the requirement for companies to publish further details for asset health measures where these are not included in PR14 Final Determination.</p> <p>Sutton and East Surrey Water, whilst supporting the principle, suggested that there should be a mutual obligation 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.</p>	<p>ODIs may have been developed taking into account a wider set of considerations. Ofwat may want to consider the merits of including delivery of the relevant NEP requirements as one of the aspects it may consider when assessing delivery of the scheme at PR19.</p> <p><b>No change required:</b> Ofwat may want to consider the merits of providing comments on the information published by the companies, to provide even greater clarity around how companies' performance would be reconciled at PR19.</p>
<p><b>A2.8 Other ODIs (SIM)<sup>5</sup></b></p>	<p>Thames Water indicated that it would welcome clarity from Ofwat on how Ofwat will be mapping SIM performance to rewards and penalties. Thames Water noted that this mapping methodology has not been included in the draft rulebook or information notes and would like to see the proposed approach in the appendices. Thames Water also highlighted that SIM scores, and the resulting rewards and penalties, can be sensitive to the specific calculation undertaken and expressed a concern that the current approach to SIM does not take proper account of regional affluence/deprivation effects.</p> <p>Severn Trent Water noted that the consultation sets out that Ofwat will retain the current magnitude of rewards and penalties for the SIM, but it does not state how it will do this. Severn Trent also indicated that, to be equivalent to the value at PR14, the SIM reward or penalty would need to be set as a percentage of forecast appointed</p>	<p><b>No change required:</b> Ofwat has already set out how rewards and penalties would be calculated. We understand Ofwat does not plan to publish the precise scoring bands before the full data set is available. However Ofwat could consider whether additional guidance is required at this stage, to provide further clarity.</p>

<sup>5</sup> In the RRB consultation, Ofwat outlined proposals for some aspects of its water trading incentive. We understand that Ofwat is considering responses on this incentive separately; it is not covered as an "other ODI" within our report.

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**Ofwat consultation  
proposal**

**Consultation response**

**Recommendation**

business turnover in 2019/20, include an allowance for tax and be indexed to nominal prices using financial year average RPI.

**Additional relevant comments**

Northumbrian Water, Thames Water, South East Water, Anglian Water and South East Water made additional specific comments in relation to the draft ODI illustrative spreadsheets:

- Two companies (Northumbrian Water and South East Water) highlighted that the final version of the model will need to accommodate additional ODIs and/or separate elements (e.g. retail)
- Three companies (Northumbrian Water and Thames Water and South East Water) highlighted an inconsistency between the spreadsheet annotation and the rulebook on the price base used for year average RCV (for the purposes of calculating Regulatory Equity) and a potential error in the calculation of the Regulatory Equity numbers in the “Aggregate caps and collars” tab
- Two companies (Thames Water and Anglian Water) commented on the rounding used in the spreadsheet. Thames Water highlighted that the draft ODI spreadsheet assumes that the PCs, deadbands and ODIs should be entered to two decimal places and noted this is not consistent with the FDs. Anglian Water suggested that actual performance should be rounded to the same number of decimal places as the performance commitment, as this would introduce more consistency and would avoid very small rewards and penalties.
- Thames Water suggested a number of additional changes to the operation of the spreadsheet:
  - In the “Numeric ODI” option, giving users the ability to overwrite calculated rewards and penalties before comparison with the aggregate cap/collar, to accommodate the design of some specific ODIs ;
  - In the “bespoke ODI option” allowing the user to input performance, the associated reward and penalty and show the underlying calculation;
  - Allowing users to input the incentive rate from the FD and show the conversion to the spreadsheet input incentive rate;
  - Allowing users to input the tax position at PR19

**Change required:** We recommend updating the illustrative spreadsheets in a number of areas:

- We recommend updating the illustrative spreadsheets to reflect the inconsistencies highlighted in the RPI series used to calculate Regulatory Equity.
- We recommend adjusting the illustrative spreadsheet to ensure that PCs and deadbands should be entered as outlined in the Final Determination (as suggested by Thames Water). We also recognise that Anglian Water’s suggested approach to rounding would introduce more consistency within a company’s Performance Commitment. We note that the spreadsheet currently has the flexibility to adopt either approach.
- We agree with Northumbrian Water and South East Water that in the final version of the ODI model at PR19, separate models will apply for different controls and each ODI will need to be modelled. The RRB illustrative spreadsheets have been prepared for illustrative purposes, therefore we do not consider they need to be expanded to accommodate all ODIs or separate elements to illustrate the operation of the rulebook at this stage.
- We acknowledge Thames Waters’ suggestions for additional features in the illustrative spreadsheets. Ofwat may wish to consider these features at PR19, when fully-specified feeder models will be required.

## 2.2. Totex incentives

The table below summarises the consultation responses on totex incentives and outlines our recommendation following consideration of these responses.

Ofwat consultation proposal	Consultation response	Recommendation
<p><b>A3.2.1 Definition of totex for the purposes of menu sharing</b></p>	<p><i>To calculate menu totex, companies must make a number of adjustments to their reported totex figure. Nine respondents agreed with the proposed approach set out in the consultation and five respondents did not comment on this issue. Of the six respondents that raised a question on menu totex, most related to the definitions of the items Ofwat is proposing to use to adjust actual totex. These are set out below:</i></p> <p><b>Fines, investigation costs and compensation claims:</b> Two companies (United Utilities and Southern Water) asked for more detail on the definition of this item. Southern Water considered that only fines imposed under section 22a of the Water Industry Act 1991 or the Competition Act 1998 should be excluded from the menu, while other fines incurred in the normal course of business should be included. Southern Water also specifically asked for more detail on “investigation costs”.</p>	<p><b>Further information or guidance:</b> As set out in the reconciliation rulebook, Ofwat plans to include a definition for ‘disallowable costs’ in the updated RAGs later this year. As part of this, we agree it would be appropriate for Ofwat to provide further detail on the definition and treatment of fines, investigation costs and compensation claims. In particular, it would be appropriate for Ofwat to add clarification to confirm that the definition of investigation costs should only refer to those “around misconduct”.</p>
	<p><b>Legacy depreciation:</b> Three respondents (United Utilities, Southern Water and South East Water) requested more detail on the definition of legacy depreciation. Southern Water stated that it was not correct to state in the rulebook that “depreciation was included in the final determination menu baseline” and, along with United Utilities, requested further clarity on its definition. Southern Water also suggested a worked example might improve understanding of this item. South East Water asked Ofwat to be clear as to the assumptions applied to depreciation when setting their baseline.</p>	<p><b>Further information or guidance:</b> We understand that legacy depreciation was not included within companies’ Final Determination menu baseline. However, it was part of companies’ wholesale allowance. We therefore recommend replacing the term “menu baseline” in the RRB with the phrase “wholesale allowance”, so the RRB reads: “this depreciation was included in the Final Determination wholesale allowance”.</p> <p>We agree that a worked example might help understanding of the application of this element.</p>

Ofwat consultation proposal	Consultation response	Recommendation
	<p><b>Cost sharing:</b> Dŵr Cymru suggested that it would be sensible to wait until the new accounting guidelines have been further embedded before concluding which totex items should be subject to cost sharing incentives, or to form a working group to discuss these issues.</p>	<p><b>No change required:</b> Under the PR14 methodology not all costs are appropriate for cost sharing, and companies have made menu choices on this basis. We note that it will always be open to Ofwat to amend the RRB if the experience of applying the new accounting guidelines suggests this is appropriate. We do not consider it necessary to delay the completion of the RRB until the accounting guidelines have been embedded. However, the adjustments set out in the rulebook for actual totex are consistent with the existing PR14 approach to cost sharing. Furthermore, companies will have an opportunity at PR19 to justify to Ofwat whether there are costs that they consider should be excluded from menu totex.</p>
	<p><b>Costs with no customer benefit:</b> Southern Water interpreted the definition of “costs with no customer benefit” as expenditure associated with a claim for a special cost factor that Ofwat did not allow in the Final Determination and that these elements should be excluded from the menu.</p>	<p><b>Further information or guidance:</b> Southern Water’s interpretation of “no customer benefit” is not correct. The concept of disallowables is used to exclude items from the menu where the activity driving them has no customer benefit (e.g. the activity is not relevant to the services provided to customers). It is not intended to capture special cost factor claims which were not allowed by Ofwat. Ofwat may want to consider providing more detail to this effect in the RAG definition of disallowables.</p>
	<p><b>Pension cash contributions:</b> United Utilities enquired whether the reference to pension cash contributions in the table defining menu totex should be limited to deficit contributions.</p>	<p><b>Further information or guidance:</b> To align with what was excluded at PR14, only pension deficit recovery costs should be excluded from actual totex. The rulebook should be updated to remove reference to pension cash contributions in the calculation of menu cost.</p>
	<p><b>Market opening costs:</b> Northumbrian Water stated that Ofwat does not make reference to excluding wholesale market opening costs from the menu, implying this was an oversight.</p>	<p><b>No change required:</b> Only 2014-15 (AMP5) market opening costs were excluded from the menu which will not be in reported AMP6 totex. All other market opening costs should be included in the menu to align with the approach taken at PR14.</p>
<p><b>A3.2.2 Treatment of inflation in totex cost sharing – Keep allowed expenditure in 2012-13 prices, and deflate actual totex using actual RPI</b></p>	<p>Ofwat received 11 responses on this issue. There was unanimous agreement on Ofwat’s approach to deflate actual totex to the PR14 2012-13 price basis by actual RPI. Bournemouth Water asked for confirmation that this calculation would use financial year average RPI.</p>	<p><b>No change required:</b> We recommend that the totex reconciliation calculations use financial year average RPI to rebase inputted values.</p>

Ofwat consultation proposal	Consultation response	Recommendation
<p><b>A3.2.3 Allocation of totex out/under performance to RCV and revenue – Use weighted average PAYG rates, with company justification otherwise</b></p>	<p>Ofwat received 14 responses on this issue. Of these, 13 respondents agreed with the proposed option in the consultation of using the weighted average PAYG rate to allocate out/under performance between RCV and revenue, although Bristol Water suggested that more flexibility would be appropriate. Severn Trent Water, the only respondent that disagreed, suggested the annual PAYG rate should be used, but did not provide further evidence to support these arguments.</p> <p>Bournemouth Water also requested that Ofwat pay some regard to the impact of AMP6 out/under performance on AMP7 bill profiles.</p>	<p><b>No change required:</b> Almost all companies supported Ofwat’s approach with no additional evidence being provided to support a change.</p> <p>On the question of profiling in AMP7, we consider this a decision to be made as part of PR19. As set out in the rulebook, Ofwat has also given companies flexibility by allowing them to propose different rates if there is a customer benefit associated with them.</p>
<p><b>A3.2.4 Treatment of the time value of money on totex sharing – Adjust all totex out / under performance for the time value of money</b></p>	<p>Ofwat received 11 responses on this issue. There was unanimous agreement on Ofwat’s approach to adjust all totex out/under performance for the time value of money.</p> <p>Severn Trent Water suggested that there was an inconsistent treatment between the application of the time value of money in the totex mechanism and other incentive mechanisms (e.g. the WRFIM).</p> <p>Thames Water asked for further clarity on how out/under performance would be profiled through AMP7.</p>	<p><b>Updates to spreadsheet required:</b> All companies supported Ofwat’s approach and we remain of the view that a time value of money adjustment on totex sharing is appropriate.</p> <p>We agree with Severn Trent Water that there is a difference in the application of time value of money between the totex mechanism and other incentive mechanisms (e.g. the WRFIM). The WRFIM is designed with a whole two year lag between when a forecasting penalty is incurred and when it applies. We recommend changing the mid-year implementation of the time value of money adjustment in the totex model to align with the other incentive mechanisms. The PR19 financial modelling should reflect this.</p> <p>In connection with Thames Water’s request, as above, on the question of profiling in AMP7, we consider this is a decision to be made as part of PR19.</p>

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**A3.2.5 Treatment of taxation on totex sharing - Only include a tax adjustment for the customer share of the RCV element of totex out/under performance in PR19**

Ofwat received 13 responses on the treatment of taxation on totex sharing, with mixed views.

Three companies (South East Water, Yorkshire Water and Southern Water) agreed with Ofwat's preferred approach of only applying a tax adjustment to the customer share of the RCV element of totex out/under performance at PR19. South West Water agreed with Ofwat's approach, but only on the condition that the totex reward/penalty element was included in revenue (and treated as post tax).

Three respondents (Bristol Water, United Utilities and Consumer Council for Water) preferred Option 2 - no adjustment. Consumer Council for Water thought there would be the negative customer perception if the companies received tax adjustments. United Utilities thought that Ofwat's option created an asymmetric approach to the tax adjustment that undermined the incentives of the totex mechanism.

Bournemouth Water and Severn Trent Water preferred Option 1 - to make a tax adjustment for the customer share of totex out/under performance in PR19. Severn Trent Water thought this method is consistent with the approach taken for legacy incentives at PR14, while Bournemouth thought Option 1 was fairer, although it should be explored further with companies.

Only Affinity Water suggested an alternative approach: this was to make a tax adjustment for RCV- related and revenue adjustments in the case of under-spend only. In their view, this would avoid blunting company incentives for underspending in period (i.e. the company is compensated for the higher tax they have paid in-period).

**No change required:** Ofwat and companies both agree that a full tax reconciliation mechanism runs counter to the regulatory objectives of incentivising companies to manage tax liabilities. However, it is appropriate to limit the degree to which tax is either compensated or borne twice and this should be incorporated, where possible, into the reconciliation mechanisms, including totex. Respondents had mixed views on how this should be implemented in the totex mechanism, and did not provide new evidence that had not been considered as part of the assessment of the options for consultation.

The current approach broadly does provide tax neutrality under simplifying assumptions. For example, where (a) the PAYG and non-PAYG components resemble operating and capital expenditure for tax, (b) there is a 100:0 cost sharing rate, and (c) the utilisation of capital allowances does not vary. It is clearly more complex within the totex menu approach where (a) operating and capital expenditure (which have different tax impacts) are not separately reconciled (b) a cost sharing rate is applied, and (c) part of the adjustment value is a reward/penalty component rather than a true-up. Only a company-specific tax reconciliation would overcome these issues.

However as some respondents have pointed out, there are other approaches which could provide greater accuracy. For example, Ofwat could provide an incremental tax allowance on the revenue adjustment at PR19, with a corresponding 'claw back' for the difference in tax during the current period. As part of this, Ofwat could take into account variances in capital allowances during the current period. This type of approach has an advantage because it accounts for differences in the tax rate between periods and is more consistent with the treatment of the ex-ante totex menu reward/penalty. But, some of these refinements may not be consistent with the regulatory regime - e.g. companies currently bear the risk of changes in taxation rates, so making additional tax adjustments which can allow for a varying tax rates may not necessarily be appropriate.

Overall, we do not consider that these alternative approaches would lead to a marked increase in precision, particularly as there would be other factors such as differences in PAYG rates, compared operating and capital proportions. This means that our current approach provides a simple method for ensuring tax is neither compensated or

borne twice in normal situations, though there will be situations where differences in allowed and paid taxation expenditure persist. Importantly, these differences can be either positive or negative, so there is no asymmetric advantage or disadvantage for companies or customers.

**Other comments**

*A number of respondents made broader comments on elements of the totex reconciliation illustrative spreadsheet. We summarise these below:*

**Reward/penalty:** South Staffordshire and Cambridge Water, Severn Trent Water and South West Water noted that the totex menu mechanism calculates the ex post reward/penalty before the application of the PAYG rate. The impact is that an element of the menu reward/penalty is included in companies' RCV adjustments.

**Change required:** To retain comparison with the treatment of the ex-ante incentive (and the CIS model) the totex reward/penalty should be wholly allocated to the revenue adjustment.

**Ex ante incentives:** South Staffordshire and Cambridge Water and Severn Trent Water also noted that the illustrative spreadsheet made no adjustment for the ex-ante additional income incentive. The additional income from the totex menu is excluded from companies' totex baselines but is applied to their allowed revenues post-financeability.

**Change required:** The additional income received by companies in their ex-ante allowances should be netted out of companies' ex-post reward/penalties. We recommend that the illustrative spreadsheet is updated to reflect this change.

As explained below, we recommend Ofwat considers the overall financeability methodology at PR19 in context of the nature and purpose of the PR14 incentive mechanisms which will apply at PR19.

**Implied and final menu choice:** This issue was not raised by respondents, but there is currently no mechanism to reconcile between allowed revenue granted under the implied menu choice and the value that would be generated using the actual menu choice.

**Change required:** We recommend Ofwat updates the illustrative spreadsheet to ensure revenues are adjusted at PR19 to account for any difference in allowed revenues that would arise from differences between the implied menu choice at Final Determinations and the final menu choice.

**Transition expenditure:** Anglian Water and Bristol Water noted that transition expenditure was incurred in 2014/15, while the totex reconciliation spreadsheet only allowed for input in cells aligned to years 2015/16 – 2019/20. They suggested the spreadsheet is adjusted to allow for input in 2014/15, with one company suggesting an entry cell for 2013/14 also.

**Accounting treatment of energy hedging:** Anglian Water raised the issue that the adoption of IFRS accounting standards has caused uncertainty on the correct treatment of energy hedging costs for at least the first two years of the price control period. They have suggested that to ensure totex out/under performance is measured appropriately elements of hedge volatility should therefore be excluded from the assessment of totex under or out performance.

**Referencing in spreadsheets:** One company stated that where the location of required input data may be subject to some interpretation that greater clarity, or specific references, would be desirable.

**Change required:** We agree that the totex reconciliation spreadsheet should be adjusted to allow transition expenditure to be input in the year it was incurred. We note that companies are currently expected to submit their actual 14/15 transition expenditure in 12/13 prices. If this is the case, no other change is required in the totex reconciliation spreadsheet, as this matches the price base the spreadsheet functions in.

However, we are unclear why an input cell is necessary for 2013/14 as the transition expenditure relevant for totex reconciliation only relates to that spent in the final (blind year) of the price control, where a forecast for transition expenditure was included in the totex baseline.

**No change required:** Only one company suggested this adjustment should be made within the reconciliation and provided only a high level argument to support a change. We note that this 'uncertainty' is not covered by an uncertainty mechanism as part of any company Final Determination. Ofwat may wish to consider this issue for PR19.

**No change required:** We agree this is an important element of the final feeder models, but given the RAGs will be updated and the final form of the PR19 data submissions are not known, adding detailed data labels to the illustrative spreadsheets may not be helpful at this stage.

Ofwat consultation proposal	Consultation response	Recommendation
<p><b>Other comments</b></p>	<p><b>PR19 financeability testing:</b> Severn Trent Water queried the application of the totex menu (and other incentives) after financeability testing at PR19. They noted that Ofwat’s approach at PR14 involved applying financeability adjustments in an NPV-neutral manner, rather than applying an NPV-positive revenue adjustment to address financeability (as had been applied in the past).</p> <p>Severn Trent Water suggested that continuing this approach would no longer be appropriate, as companies will receive a negative adjustment at PR19 for being efficient in AMP6 (via the totex menu). This implies that to remain credit worthy in future, a company should avoid excessive outperformance and rather re-invest any efficiency savings. Severn Trent Water considered this could have negative customer impacts and hence did not agree that all financeability issues are ‘green’ in the RRB consultation assessment.</p>	<p><b>No change required:</b> We agree that the operation of the totex reconciliation mechanism means that companies that are more efficient on totex compared to their Final Determination will need to ‘hand back’ part of their totex savings to customers at PR19. This appears as a negative adjustment at PR19. However, the incentive allows companies to <i>retain</i> a proportion of their totex savings which could alternatively be viewed as a positive adjustment compared to a counterfactual where companies hand back the full savings.</p> <p>Nonetheless, Ofwat may wish to consider its PR19 financeability methodology in light of the PR14 reconciliation mechanisms which will apply at PR19.</p>

## 2.3 Wholesale Revenue Forecasting Incentive Mechanism

The table below summarises the consultation responses on the WRFIM and outlines our recommendation following consideration of these responses.

Ofwat consultation proposal	Consultation response	Recommendation
<p><b>A3.3.1 Treatment in WRFIM of revenue from “in-period” ODIs – Include ODI rewards and penalties in the allowed revenues for WRFIM calculation</b></p>	<p>Thirteen respondents support the proposal to include in-period ODIs in the allowed revenues that are inputs in the WRFIM formula. While some respondents did not provide comments, there were no objections to this approach.</p> <p>Bournemouth Water highlight an inconsistency in the consultation between the text on page 40 which refers to including revenue changes relating to in-period ODIs, and Table 2 on page 7, which refers to excluding them. As a result they state they are unclear on the proposal and present their own interpretation which is to adjust allowed revenues for companies with in-period ODIs so that they will receive the Final Determination allowed revenue ± the net ODI value.</p> <p>Dŵr Cymru noted that this approach could be extended for a number of other cases, for example: support for social tariffs which are part-funded by companies in the form of voluntary revenue abatements and in-period adjustments for the RCM true-up of the PR09 blind year (2014/15).</p>	<p><b>No change required:</b> The WRFIM could either include, or exclude, the revenue from ODIs in the definition of both allowed and actual revenue. Notwithstanding, we agree that it would be consistent with the treatment of ODIs in the (draft) RRB if the Table on page 7 read “<b>Include</b> revenue changes from in-period ODIs from WRFIM reconciliation”.</p> <p>Dŵr Cymru note that the adjustments within WRFIM could be extended to other components of the price control. However, other in-period adjustments do not appear to feature in the PR14 methodology and may require modified licence conditions. Ofwat may wish to consider these additional items further.</p> <p>For avoidance of doubt, the definition of ‘allowed revenues’ within the WRFIM (used to calculate over or under recovery of revenues when compared to actual recovered revenue) includes any in-period adjustments relevant to ODIs.</p>

Ofwat consultation proposal	Consultation response	Recommendation
<p><b>A3.3.2 Treatment of taxation in WRFIM – Do not include tax adjustment on the revenue changes that result from WRFIM</b></p>	<p>Ten respondents supported the proposal to not include a tax adjustment on the revenue changes that result from WRFIM in PR19 (Option 2). Seven companies did not provide comments on this approach.</p> <p>Three respondents objected to the proposal. We note that:</p> <ul style="list-style-type: none"> <li>• Severn Trent Water consider this position on tax could lead to the undesired outcome of customers paying twice for taxation.</li> <li>• Thames Water are concerned the tax treatment means that companies bear the consequence of any tax rate changes during AMP6.</li> <li>• Affinity Water are doubtful about the proposal as it does not treat over and under-recoveries equally.</li> </ul>	<p><b>No change required:</b> As noted above, Ofwat and companies generally agree that a full tax reconciliation mechanism runs counter to the regulatory objectives of incentivising companies to manage tax liabilities. However, it is appropriate to limit the degree to which tax is either compensated or borne twice and this should be incorporated, where possible, into the reconciliation mechanisms, including WRFIM. Most respondents supported the proposal not to include a tax adjustment, though there were some objections.</p> <p>We do not consider that this approach would lead to customers paying twice for taxation. The approach is to (broadly) offset the variance in tax during the price control period by providing no incremental tax allowance on the WRFIM revenue adjustment in the next price control period. This approach involves ‘ring-fencing’ the AMP7 revenue adjustment from the calculation of the AMP7 tax allowance at PR19.</p> <p>This approach is broadly tax neutral in a simple scenario. It may be beneficial to provide a simple illustrative example in the RRB. In practice, differences may occur because companies’ effective tax rates or the statutory tax rates are different between periods. These changes would lead to differences in the level of tax passed between periods, but we do not consider this would result in double counting. We agree with Thames Water that the approach places the risk of tax changes during AMP6 on companies. An alternative approach would be to equalise the tax over/under recovered between periods, by taking account of the difference in tax rates.</p> <p>However, we understand that the PR14 methodology does not include a full tax reconciliation to reflect these types of changes.</p>

Ofwat consultation proposal	Consultation response	Recommendation
<p><b>A3.3.3 Treatment of blind year – Make an adjustment in PR19 for the blind year based on forecast outturn</b></p>	<p>Eleven respondents supported the proposal to make an adjustment in PR19 for the blind year based on forecast outturns. The Consumer Council for Water stated that Ofwat should consult further with the industry on the estimation techniques they intend to use in making the adjustment, whilst agreeing in principle. Seven companies did not provide comments on this approach.</p> <p>Two respondents, Severn Trent Water and Thames Water disagreed with the proposal. They do not think there is a need for the blind year adjustment as they consider it very unlikely companies will forecast revenues that do not match the allowance in 2019-20.</p>	<p><b>No change required:</b> Whilst noting the Consumer Council for Water’s comment, we understand that Ofwat expects companies will match their forecast of final year revenues with (adjusted) allowed revenues and therefore estimation techniques are not likely to be relevant. Ofwat may wish to make an adjustment at PR24 if companies’ actual revenues in 2019-20 are different to the forecast applied at PR19.</p>
	<p>Respondents requested additional clarity around the definition of “recovered revenue” within the WRFIM</p>	<p><b>Further information or guidance:</b> We agree it would be helpful for the rulebook to explain the mapping between the WRFIM inputs and the relevant RAG pro-forma. ‘Recovered revenue’ is the wholesale charge revenue for water/ wastewater from the current RAG pro forma 2I – ‘Total revenue governed by wholesale price control (row 38 columns C and D). This reference will need to be updated if the RAG pro forma changes in future.</p>
<p><b>Additional relevant comments</b></p>	<p>Wessex Water Services Ltd. Has requested further clarity over whether they can request additional revenue for new connections as was stated in their Final Determination.</p>	<p><b>Further information or guidance:</b> In line with the Final Determination, we recommend that the following wording should be included in the RRB in order to give greater clarity to companies.</p> <p>‘If a company increased revenue by unduly reducing connection charges we may take corrective action to ensure that companies returned these monies (with financing costs) to customers. Similarly, although we have decided not to allow automatic adjustments to allowed revenues for demand variations in wholesale controls, if demand for connections is unexpectedly high then we would nevertheless consider allowing extra revenue to compensate for the loss of price control revenue on a case-by-case basis.’</p>

## Ofwat consultation proposal

## Consultation response

## Recommendation

Two companies questioned the use of November RPI as opposed to average RPI and one respondent requested further clarity on the use of RPI.

**No change required:** Consistent with the calculation of allowed revenues and the published WRFIM formula, both allowed revenues and WRFIM penalties are intended to be indexed using November RPI. Under the PR14 methodology, this is (intentionally) different to the RPI used to implement other mechanisms which have a different price base for the allowed/actual information being compared.

Dŵr Cymru raised a concern about the “unintentional” compounding effect of imposing penalties upon penalties within the WRFIM.

**Finely balanced recommendation – no change required:** We note that the true-up at PR19 is determined by the adjustments at 4<sup>th</sup> and 5<sup>th</sup> years (i.e. 2018-19 and 2019-20) calculated from WRFIM formula.

The compounding effect only applies to the adjustment of 5<sup>th</sup> year, which rolls forward the penalty at 1<sup>st</sup> year from the 3<sup>rd</sup> year to the 5<sup>th</sup> year. However, the magnitude of this compounding effect of penalty is insignificant, because the upper bound of the effect, when imposing the maximum penalty rate of 3% in both the 3<sup>rd</sup> year and 5<sup>th</sup> year, is 0.09% (i.e. 3% times 3%) of the revenue deviation between collected and allowed revenues in the 1<sup>st</sup> year. On the other hand, the current design of the mechanism with this insignificant compounding effect of penalty has the benefit of simplicity for implementation. Therefore, we recommend Ofwat confirm the penalty formula per the published WRFIM (though subject to Ofwat’s final position on the structure of the overall WRFIM – see below).

## Ofwat consultation proposal

## Consultation response

## Recommendation

Severn Trent Water, Thames Water, Anglian Water and Wessex Water Services Ltd. Noted there is a possible unintended consequence in the application of the WRFIM formula which applies penalties for both under and over-recovery of revenues. They noted that where there is an under-recovery of revenues in one year they cannot subsequently over-recover to compensate for this due to the constraints of their licence which forms a cap on revenue.

**Change required:** During PR14, Ofwat consulted on the proposed WRFIM policy and published the final WRFIM formula alongside the PR14 final determinations. The operation of the mechanism, as set out in those documents, works where companies can smooth over *and under-recovery* of revenue to remove the compounding effect of penalties over the five year price control period.

The WRFIM set out in the RRB is consistent with the policy intention expressed in the PR14 documents. A one way mechanism (for example, the alternative method suggested by Thames Water) would not be. On this basis, Ofwat could continue with the current approach which is designed to incentivise companies to improve the way they forecast wholesale revenues within the new flexible wholesale revenue controls.

However, we recommend that Ofwat considers the legal implications of the published WRFIM formula to determine the most appropriate way to respond to companies' concerns. We acknowledge that companies may be prevented from deliberately over-recovering revenue from customers in their licence which could hamper their ability to respond to the WRFIM incentives within the period, i.e. over-recover to prevent further penalty. Therefore, Ofwat could consider deviating from the published formula. In which case, Ofwat could either adjust the WRFIM formula, or consult on licence changes which would allow companies to smooth their revenue in-period.

## Ofwat consultation proposal

## Consultation response

## Recommendation

### Additional relevant comments – Modelling

Three respondents raised queries with the calculations implemented in the supporting illustrative spreadsheets.

- South Staffordshire and Cambridge Water requested that the WRFIM penalty components be split into two components (indexation and penalty) for transparency. They also pointed out a typo in the RPI used for uplift in the illustrative example.
- Anglian Water requested the spreadsheet be made clear that in period ODIs are included in the allowed revenues.
- Thames pointed out an issue in the way the illustrative spreadsheets compounded RPI from 2012-13 to 2016-17 and then 2012-13 to 2017-18 prices. Thames Water also noted that the spreadsheet requires the allowed revenue for water and wastewater to be entered at 2012-13 price base. If this is taken from the wholesale allowed revenue shown in the Final Determination company-specific appendix, e.g. water Table A2.10 final row, the re-pricing applied in the Ofwat excel spreadsheet will not generate the correct allowed revenue to be used as the basis for companies' price setting.

**Change required:** While the WRFIM formula combines both elements in a single calculation (as reflected in the draft spreadsheets), it is straightforward to separate the calculation to its separate components.

We recommend that the compounding RPI issue identified by Thames Water and South Staffordshire and Cambridge Water is addressed within the illustrative WRFIM example, as part of the overall spreadsheet review process. Likewise, we recommend that the price base issue identified by Thames Water is addressed in the illustrative spreadsheet.

## 2.4 Reconciliation of PR09 incentives

The table below summarises the consultation responses on the reconciliation of PR09 incentives and outlines our recommendation following consideration of these responses.

Ofwat consultation proposal	Consultation response	Recommendation
<p><b>A4.2 Indexation in the CIS RCV adjustment – Adjust the RCV in PR19 to remove the balance relating to the use of different indexation approaches</b></p>	<p>Ofwat received responses from all 18 companies, and one each from the Consumer Council for Water and the Environment Agency, on the question of whether the RCV should be adjusted at PR19 to remove the amount remaining in the RCV from the use of different indexation assumptions in the CIS model at PR14.</p> <p>Six respondents (Bournemouth Water, South West Water, United Utilities, Wessex Water Services Ltd., the Consumer Council for Water and the Environment Agency) did not oppose Ofwat’s proposal to adjust the RCV at PR19. Of these six, Wessex Water Services Ltd. Asked Ofwat to profile the RCV adjustment through AMP7 rather than make a midnight adjustment on 31<sup>st</sup> March 2020 and South West Water stated that Ofwat should provide clear evidence as to why the approach used in the Final Determination CIS model was incorrect. Dee Valley Water neither disagreed nor agreed with Ofwat’s suggested approach, but highlighted the importance of regulatory certainty.</p> <p>The remaining 13 respondents were opposed to Ofwat’s proposal. Eight respondents (Northumbrian Water, Portsmouth Water, South East Water, South Staffordshire and Cambridge Water, Dŵr Cymru, Anglian Water, Affinity Water and Yorkshire Water) cited the importance that Ofwat maintain regulatory certainty and/or consistency with the published Final Determinations. Both Anglian Water and Dŵr Cymru believe the approach currently applied in the CIS model is correct. Northumbrian Water and Affinity Water have also said that the existence of alternative options in the Final Determination undermines the need for a change now. In addition, Affinity Water has suggested that the ‘Do no harm’ principle for enhanced companies should be extended to</p>	<p><b>Further information or guidance:</b> The majority of the responses on this topic have focused on the appropriateness of the adjustment, not how it should be made. Only one respondent (Bristol Water) suggested an alternative approach and has provided supporting analysis. We have reviewed this analysis and consider the proposal would not correctly adjust the RCV to replace forecast capital expenditure at PR09 with actual capital expenditure in the AMP5 period. The approach proposed by Bristol Water results in additions to the RCV equivalent to AMP5 capital expenditure multiplied by forecast minus actual real price effects. Under Bristol Water’s approach, companies would have received positive RCV adjustments for outturn real effects being lower than those forecast in the Final Determinations.</p> <p>Ofwat’s proposed approach to the CIS adjustment would protect companies against real price effects and is consistent with the approach set out in the PR09 Final Determinations, which stated that the RCV should be adjusted for actual capital expenditure. We have not seen any convincing arguments to suggest a change in Ofwat’s approach to calculating the adjustment. We therefore recommend that Ofwat does not change the calculation approach.</p> <p>However, given the number and nature of responses in opposition to the principle of making an RCV adjustment, we consider there are issues that Ofwat may need to provide guidance or give further thought to. In particular, Ofwat may want to consider further the impact of the adjustment on the shadow RCV and company financeability. A number of companies highlighted that the shadow RCV should be protected from any impact of the RCV adjustment as the adjustment will have immediate impacts on it. It is possible that investors or creditors could use the shadow RCV including the adjustment in their calculations of company valuations and debt capacities.</p>

## Ofwat consultation proposal

## Consultation response

## Recommendation

encompass the RCV adjustment and also that it would be disproportionate to change the approach to indexation when it would be one of a number of changes at PR19.

Of the remaining five respondents, Severn Trent Water has explained that they may have changed their recommendations to their Board at Final Determinations, had the extent of the RCV adjustment been better known at the time. Thames Water and South East Water have referred to and referenced the extent of communication and correspondence between Ofwat and the companies over a number of years before and during PR14. These two respondents are not convinced a sufficient case for change has been presented by Ofwat and that Ofwat has not considered the implications the adjustment will have on companies' finances and shadow RCV during AMP6. Thames Water and Southern Water have also suggested further analysis is completed to understand the full impact of the change and whether other options are available. Sutton & East Surrey Water has not recognised the CIS issue as part of the rulebook as it is not a clarification of a factor in the PR14 FD, but rather a material change to the Final Determination.

Only Bristol Water suggested an alternative approach to making the RCV adjustment that uses Actual COPI rather than Final Determination COPI to adjust allowed capex. Bristol Water states, however, that the choice of approach is dependent on Ofwat's intended risk allocation at PR09.

Finally two respondents, Northumbrian Water and Severn Trent Water have suggested that the shadow RCV should be protected by ensuing the change is made in the midnight adjustment at PR19, or that an alternative shadow RCV without the adjustment is published. Severn Trent also suggests the RCV adjustment could reduce the rating that credit rating agencies apply to the UK regulated sector.

Ofwat consultation proposal	Consultation response	Recommendation
<p><b>A4.3 Blind year reconciliation: use of materiality thresholds – Apply a materiality threshold in aggregate to revenue and RCV adjustments</b></p>	<p>Eight companies agreed with this proposal. Given the complex interaction between legacy RCV adjustments, revenue adjustments, and final inflation indices, two companies highlighted the need for individual companies’ circumstances to be considered when determining the interaction of materiality tests.</p> <p>Eight companies disagreed with the proposal for Option 2 - to apply a materiality threshold in aggregate to revenue and RCV adjustments. In summary, companies consider this approach inconsistent with the way mechanisms were dealt with at Final Determination as no materiality threshold was used. Bristol Water considered that Option 1 (adjust each of the mechanisms in full in PR19, with no threshold for materiality) is more appropriate, particularly in light of Ofwat’s own analysis against the assessment criteria.</p> <p>Two companies requested clarity on whether land sales are included in the reconciliation as this was referenced in the consultation document but not the reconciliation rulebook.</p> <p>Five companies provided no comment on this approach.</p>	<p><b>Change required:</b> We recommend Ofwat considers removing the materiality threshold for the blind year reconciliation, or reducing the threshold to a trivial level.</p> <p>While the intention behind the current approach was to maintain consistency with the wording set out in the Final Determination<sup>6</sup> we agree that it would not be strictly consistent with the approach taken for the first four years of the PRO9 incentive mechanisms (where there was no materiality threshold). Moreover, we consider the statement in the Final Determination did not necessarily commit Ofwat to the use of a materiality threshold in adopting a proportionate approach. As such, Ofwat could consider removing the materiality threshold or amending it to reflect a trivial amount.</p> <p>In addition, we recommend that Ofwat run the appropriate calculations to determine the blind year adjustments based on company submissions of actual performance for the final year of the price control; this information will include land sales which will be reconciled alongside the PRO9 incentive mechanisms.</p>

<sup>6</sup> The Final Determination stated the following: ‘In carrying out this reconciliation we will take a proportionate approach (for example, applying materiality thresholds where appropriate) to making adjustments for company’s actual performance and implement these changes at the next wholesale price control review in 2019.’

Ofwat consultation proposal	Consultation response	Recommendation
<p><b>A4.4 COPI updates for the CIS model – Adjust COPI in the CIS models when updated data becomes available</b></p>	<p>Thirteen respondents agree with the proposal for Option 1 to adjust COPI in the CIS models when updated data becomes available. Five respondents provided no comment.</p> <p>Two respondents object to this proposal. We note that:</p> <ul style="list-style-type: none"> <li>• South Staffordshire and Cambridge Water requested for Ofwat to confirm that if a new COPI index is published it will not impact on the CIS models used for 2010 – 2014 where previously published data has already been used.</li> <li>• Yorkshire Water considered none of the three options provided are suitable. They would instead recommend for the first three years of the CIS adjustments to remain at the agreed FD14 position and would allow the final two years to be assessed using published data.</li> </ul> <p>South West Water queried whether the RCM should be excluded from the blind year materiality calculation, in which case there would be no need to delay RCM because of COPI.</p>	<p><b>No change required:</b> The PR09 CIS incentive mechanism operates on a 5 year basis and while the actual capital expenditure data will not be revisited for 2010-2014, the provisional COPI data will be refreshed with firm data where possible or alternatively a reconciliation to the updated ONS approach when published.</p> <p>We recommend that the RRB include some additional drafting to clarify its intended approach to reconciling the existing and future COPI data to the new calculation methodology when this is determined by ONS; in particular we recommend that Ofwat confirms that the actual capital expenditure data for 2010-14 will remain unchanged from the Final Determination.</p> <p>While the RCM could be excluded from the blind year materiality calculation (and therefore not depend on the timing of COPI), this will depend on Ofwat’s final approach to the blind year materiality threshold which we recommend removing (see A4.3 above) and the approach to WRFIM (which may limit companies’ ability to recover RCM variations during AMP6 (see WRFIM ‘additional relevant comments’ above).</p>
<p><b>A 4.5 The treatment of PR09 reconciliation adjustments in the PR19 review</b></p>	<p>Ofwat received three responses on this item all agreeing with the proposal to adjust PR09 reconciliation adjustments at PR19 in line with the approach taken at PR14, for indexation, taxation and the time value of money.</p>	<p><b>No change required.</b></p>
<p><b>Additional relevant comments – Land sales</b></p>	<p>United Utilities observed there is no adjustment made within the blind year adjustment mechanism for variances in outturn land sales.</p>	<p><b>Updates to spreadsheet required:</b> We recommend that the RRB (and illustrative blind year adjustment spreadsheet) should be updated to take account of variations in land sales which are not captured within any of the incentive mechanisms.</p>
<p><b>Additional relevant comments - Modelling</b></p>	<p>Thames Water noted that there is an error in the calculation of the RCV PR19 adjustment, specifically that the RCV run-off rate for Wholesale Wastewater should exclude the Thames Tideway Tunnel (TTT) because the CIS does not apply to expenditure on the TTT.</p>	<p><b>Updates to spreadsheet required:</b> We recommend that the run-off rate assumption used in the calculation for Thames Water should be taken from the Ofwat Final Determination model for wholesale excluding the TTT (rather than, as in the consultation document, from the Wholesale including TWUL-delivered TTT).</p>

**Ofwat  
consultation  
proposal**

**Consultation response**

**Recommendation**

United Utilities noted that the total adjustment due to financing costs revenue calculation is based upon the value being greater than zero, so that only positive adjustments are displayed.

**Update to spreadsheet required:** We recommend that the formula which implements the time value of money adjustment in the blind year adjustment spreadsheet should be amended so that it is capable of showing negative adjustments.

## 2.5 Household retail

The table below summarises the consultation responses on household retail and outlines our recommendation following consideration of these responses.

Ofwat consultation proposal	Consultation response	Recommendation
<p><b>A5.2 Reconciliation of household retail control- A revenue wash-up at the end of the period</b></p>	<p>Ten respondents agreed with the proposal for Option 2: a revenue wash-up at the end of the period, and seven respondents did not respond to this approach.</p> <p>Two respondents (Portsmouth Water, Sutton and East Surrey Water and) have objected to this proposal. Some companies disagree with the need for any reconciliation on retail revenues. Portsmouth Water indicated a preference for Option 4 (not to include any further reconciliation mechanism). Sutton and East Surrey Water indicated that there may not be a need for a household retail “wash up” if governance and assurance remain robust.</p>	<p><b>No change required:</b> No additional evidence was provided by companies to suggest that the approach outlined in the consultation document is incorrect. In addition, respondents did not provide a convincing argument against the reconciliation of household retail revenues at PR19, though we note that some respondents thought the wash up was unnecessary.</p>
<p><b>A5.3 Treatment of time value of money – Financing cost adjustment where material adjustment</b></p>	<p>There was no consensus between companies on this proposal with an equal number of companies agreeing and disagreeing.</p> <p>The Consumer Council for Water and Southern Water both agreed with the proposal to not adjust for the time value of money. However, both sought further clarification on what constitutes “material”. This view has also been reiterated by South East Water who do not support the proposal.</p> <p>Yorkshire Water, Thames Water and Anglian Water Services Ltd. all objected to the proposal. These companies considered there should be a financing cost adjustment and this should not be based on the level of materiality. If materiality is to be used, they suggested this should be specified now rather than at the next price control.</p> <p>Nine companies did not respond to this approach.</p>	<p><b>Finely balanced recommendation - further information or guidance:</b> We remain of the view that there is a good case for applying a time value of money adjustment. However, because variances are not expected to be material, we do not consider there is a strong requirement to do so. We also note that an appropriate retail discount rate would be needed to implement the financing cost adjustment, and one was not determined at PR14.</p> <p>We consider that it would be more transparent if Ofwat provided details on the materiality threshold it would apply before considering whether a time value of money adjustment was appropriate. A materiality threshold of 2% of annual household revenue would be consistent with the penalty threshold set in the WRFIM formula.</p>

Ofwat consultation proposal	Consultation response	Recommendation
<p><b>A5.4 Treatment of taxation – Do not use a tax adjustment</b></p>	<p>Six companies supported the proposal for Option 2 to not include a tax adjustment. Twelve companies did not provide a response to this approach.</p> <p>Two companies, Thames Water and Affinity Water, objected to this proposal. The former is concerned the treatment places exposes companies to the consequence of tax rate changes during AMP6, and would instead suggest adjusting tax at both the position set at the PR14 and at PR19. Affinity Water believed not including tax adjustments neglects the equal treatment of over and under-recoveries.</p>	<p><b>No change required:</b> We consider that revenue over and under-recoveries are treated in a broadly equivalent way under the preferred option (all else being equal). Similar to the approach for WRFIM adjustments, this approach involves ‘ring-fencing’ the AMP7 revenue adjustment from the calculation of the AMP7 tax allowance at PR19 (i.e. the adjustment is added to allowed revenue, but only <i>after</i> the calculation of the tax allowance) to avoid any double counting. We consider that it would be helpful for the RRB to include a simple worked example of the approach.</p> <p>As noted above, we agree that the approach places the risk of tax changes during AMP6 on companies. We are not aware that Ofwat’s methodology for PR14 reflects an intention to conduct a full tax reconciliation to reflect these types of changes, though Ofwat may wish to consider the merits of adopting Thames Waters’ suggestion.</p>
<p><b>Additional relevant comments</b></p>	<p>Thames Water noted that the proposed adjustment resulting from the reconciliation of household revenues is spread over AMP7 as opposed to a one off adjustment.</p>	<p><b>No change required:</b> The RRB calculates the aggregate revenue adjustment as a single one-off value, however it does not determine how this adjustment should be profiled over AMP7. We recommend that Ofwat address the profile of revenue adjustments at PR19 (both for the household retail mechanism and other mechanisms which result in a revenue adjustment at PR19).</p>
<p><b>Additional relevant comments - Modelling</b></p>	<p>South Staffordshire and Cambridge Water noted that the units in the household retail reconciliation spreadsheet are in £ rather than £m. In addition, South Staffordshire &amp; Cambridge Water noted that there is an inconsistency between the spreadsheet and the RRB where forecast customer numbers are not explicitly referenced in the spreadsheet.</p> <p>Thames Water noted that customer numbers are specified to be input to the spreadsheet (“Inputs” tab) in millions, with zero decimal places, whereas the PR14 FD models used the number of customers to the nearest single customer. Thames Water considered that customer numbers entered in millions should be entered to six decimal places.</p>	<p><b>Updates to spreadsheet required:</b> We recommend making minor updates to the spreadsheet to ensure consistency between the inputs and steps outlined in the RRB and the illustrative spreadsheet.</p>





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