

# Response to Ofwat's consultation on the PR14 Rulebook - May 2015

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## Responding to this Consultation

We welcome the publication of a draft PR14 reconciliation rulebook and the chance to respond on this before its finalisation.

We agree with Cathryn Ross's view that a regulator should aim to set incentives for company boards that align stakeholder and investor interests; we should not need to horse-trade between the two. Our suggestions for changes are set within this context, and if taken up, should act to improve the outcome of the incentives that are in the long-run beneficial to both consumers and investors.

The rulebook now provides the details of the incentives faced by company boards over the next five years. To be effective, incentives need to be:

- Transparent
- Simple to understand
- Coherent, and unlikely to deliver perverse outcomes
- Trusted by those to whom the incentive is directed

The first part of our response follows these themes. We recognise your request to tie all of our comments back to Ofwat's statutory duties, but we don't think that it is always beneficial to look at each individual decision with the view that it can only either benefit customers or investors through the consumer and financing duties. We should instead look at the package of incentives overall to see if it is likely to fulfil Ofwat's duties overall and wider government aspirations for the sector.

Secondly, we provide a summary of our recommended changes to the rulebook. We would of course be happy to provide more detail on any of these if requested.

This section also contains some assumptions that we have had to make about how these mechanisms will be applied and the messages we will give our board and stakeholders. Where you believe our assumptions are incorrect we would be grateful if you would inform us of this as soon as possible.

We also provide as an appendix our views on the items that we believe are included in the wholesale revenue cap and those which are not. If this is inconsistent with Ofwat's views again we would be grateful if you could inform us of this as soon as possible.

## Transparency

Ofwat paid greater attention at PR14 to the potential risks to and rewards above the central equity return than at previous price reviews and explicitly expected companies to consider these issues in the light of future financeability, and in terms of the risk/reward balance reach company's board wished to strike.

We understand that the amount of change in PR14 meant that the methodology was still developing through the process. We also recognise and give credit for the fact that this publication is a step forward from AMP5 where there was uncertainty even over whether certain incentives still existed.

However it remains true that boards were being asked to make decisions on risk and reward with at best incomplete information about the incentives that are now being detailed. Best practice would be to issue a document such as this in advance of (not following) a business plan submission and certainly before a price determination. As it is clear that there is the potential for more significant change in PR19 we request that you commit now to greater clarity in any changes to incentive mechanisms in advance of company boards approving their business plans. In particular we would welcome publication in tandem with the PR19 methodology.

Similarly, it would be poor for trust and confidence in the industry if at PR19 companies were again criticised for misinterpreting Ofwat's intentions in these incentives in their submissions. In this light we think you should avoid retaining discretion over certain items in the rulebook, for instance in the retail household true-up Ofwat retains the ability to make a time value of money adjustment in the true-up if the value is "material". In this case an ex ante definition of materiality would suffice to ensure that companies had the necessary clarity.

Most mechanisms are clear in their effect, the WRFIM mechanism however suffers from a significant lack of clarity and transparency. At its most basic level it is not clear whether the "incentive under the WRFIM" (which companies are able to challenge the applicability of through representations) is just the penalty associated with under and over recovery of revenues above the 2% threshold, or whether as was stated at the time of the FD, that companies can challenge the revenue allowance itself (and the associated true-up) in the light of significant demand changes. Our final determination included a commitment from Ofwat as follows:

*"As set out in our final methodology statement 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. We consider that Hinkley Point capital contribution due to size and scale of individual project is likely to require adjustment at the next price review as part of PR14 reconciliations."*

We therefore request that the rulebook contains a confirmation that companies can propose (and that Ofwat will accept in some circumstances) an amendment to allowed wholesale revenues because of demand changes.

In addition there is a lack of clarity on the WRFIM as to the revenue streams that are and are not included in the wholesale revenue cap. We request that you provide more clarity, and to assist this we have provided a list of our revenue streams and our view on whether the revenue cap applies in an appendix to this document. We would be happy to discuss this further.

The WRFIM indexation rules also remain ambiguous, one possible reading of the rulebook and the wording in the associated spreadsheet is that it is your intention to compare outturn revenues that are tied to actual November RPI with the outturn revenues assumed at PR14 (with Ofwat's assumed RPI) and then true-up the difference at the end of the AMP (including that caused by the difference between actual RPI and that assumed at the FD). We doubt that this is the intention because it would be a fundamental shift away from RPI indexation contained within company Licences that would need to be subject to much wider debate and consultation and for the avoidance of doubt would be a

move that at this stage we could not support. We request however that you provide greater clarity on this point.

We also note that the WRFIM treatment of indexation of revenues is different to that used to create the “allowed revenues” that form part of the price control 2014-15 allowances on which RPI and K are applied in future years and therefore our Licence. We would expect these to be consistent.

### **Simplicity**

Incentives need to be understood by company boards so that they can take effective management action to respond to them.

Where incentives directly relate to services received by stakeholders, in particular company performance commitments, there should be an even greater degree of simplicity so that companies are able to explain these easily to customers in a way that builds trust.

There is often a trade-off between the theoretical accuracy of and the simplicity of incentives. In our view where incentives are directly impacting on performance commitments we should err further towards the side of simplicity in our choices. For this reason we agree with your proposal to ignore the time value of money concept when assessing rewards and penalties on performance commitments. Including it will reduce understanding of the incentives for both customers and companies, and while this may be considered less accurate we do not think that this will in practice change company behaviour.

We would support however time value of money concepts being used in the totex under/out performance mechanisms as the values are likely to be more material and may drive company behaviour inappropriately if incentives to become more efficient are variable depending on the year in which the efficiency is made.

### **Coherence**

Overall we consider that, with some changes and clarifications as suggested in this document, that in most cases the set of incentives as detailed in the rulebook will provide a coherent set of incentives.

We recognise that decisions to allow for time value of money in some incentive mechanisms but not others may create some inconsistencies but we do not believe this has a material impact on the overall coherence of the incentive package.

An exception to this is the WRFIM mechanism where the interaction with our Licence does not produce a coherent set of incentives.

As written it would be possible for a company to suffer unavoidable penalties under this mechanism in the event that it under-recovers revenues in one year because the mechanism implies that the company should aim to recover the under-recovered revenue two years later. However this would require the company board to approve charges that were deliberately set to over-recover charges in that year compared to its Licence.

There is a further inconsistency in that the Final Determination states that customer bills will be impacted by the operation of the WRFIM “from”(not before) 2020. This implies that company boards should always aim to recover only the amount of revenue allowed in the Licence, and in all cases ignore the operation of the WRFIM even when by doing so they will increase the chances of suffering a WRFIM penalty.

It would be a curious outcome if our board was expected to ignore an incentive and was not able to take appropriate action to avoid a financial penalty. For this reason our view is that it is your intention is for company boards to take into account under and over recovery of revenues in previous years during the AMP6 period when setting charges, and we believe that this approach would be in the best interests of customers as it is less likely to mean companies consistently over recovering revenues within the period.

If our assumption above is correct then it would be helpful if you clarified the FD statement that the WRFIM will not impact on customer bills before 2020 and that you expect company boards to take into account the WRFIM when setting charges, even if this means aiming to slightly over-recover the allowed revenues in a particular year compared to the licence allowance.

If you are unable to do this the WRFIM mechanism should instead be amended so that it is consistent with the licence so that in each year companies are given a financial incentive to recover revenues consistent with their licence, and where any net over and under recovery at the end of the period is dealt with in a true-up at PR19 as per the existing RCM.

### **Trusted**

Companies and their investors need to trust that Ofwat will apply the incentives fairly and consistently if they are to respond to them. This ultimately acts to the benefit of customers as regulatory confidence will reduce financing costs.

The publication of this rulebook for PR14 is helpful, albeit there are some areas already mentioned where greater clarity, consistency and certainty of approach would further increase trust.

The proposed changes to the calculation of the PR09 CIS mechanism have the potential to damage this confidence. We believe that Ofwat has gone some way to responding to this risk by its proposal not to make the RCV adjustment implied by its revised calculation until 2020. As it stands however companies will still have to act during the 2015-20 period with the knowledge that there will be a reduction to the RCV on the 1<sup>st</sup> April 2020. This still then has the effect of a retrospective RCV adjustment following a business planning process that was undertaken on a different set of assumptions.

We think you should take one additional step to lessen any potential damage to trust and confidence by smoothing the adjustment made to the RCV across the following AMP (with a revenue adjustment to ensure NPV neutrality). This will allow companies to take steps in their PR19 submissions to allow for the majority of this RCV adjustment and ensure continued financeability without acting to the detriment of consumers.

This approach is not new to the water sector; in the past a proportion of all RCV midnight adjustments were in fact smoothed over the following AMP period.

For reasons of investor confidence and financeability and to the ultimate benefit of consumers, our preference would be for all midnight RCV adjustments to be smoothed over a five year period (in an NPV neutral way) to lessen the volatility of the RCV and of customer bills.

### **Other items**

In your consultation document you have set out some options surrounding the particular decisions you have made. Unless stated otherwise we accept your chosen options, in particular we accept your

decisions around time value of money, taxation and on materiality for PR09 final year adjustments as reasonable ones. For the CIS adjustment we have proposed a change to the way you apply the future RCV adjustment rather than accept either of your “do something” or “do nothing” options in their entirety.

### **Next steps**

We have set out our overall approach and views above and we summarise our recommendations in the next section.

This is obviously a technical area so we would be happy to give additional detail if you require this. We would also be happy to meet to discuss any of the issues raised.

If you would find this helpful please contact Phil Wickens, head of economic regulation to arrange a mutually convenient time. Please contact him on 01225 526351 or via email at [phil.wickens@wessexwater.co.uk](mailto:phil.wickens@wessexwater.co.uk).

## Wessex Water Recommendations

1. It would be helpful if you could commit now to greater clarity in any changes to incentive mechanisms at PR19 by publishing a similar rulebook in advance of company Board's approving their business plans.
2. You should define in the rulebook what you mean by "material" when assessing whether a time value of money adjustment should be made in the retail household revenue true-up.
3. We recommend you correct or clarify your statement in the Final Determination that the WRFIM mechanism will only impact on customer bills "from 2020". You should state instead that you expect 2015-20 revenues to be impacted by the WRFIM mechanism and specifically that you will allow company boards to aim to over-recover allowed wholesale revenues (as defined by the Licence) in particular years if this is in the context of avoiding a potential financial penalty under the WRFIM mechanism. On balance we believe this is your intention and we therefore expect to ask our board to take this approach in future years. If we have misinterpreted your intention please let us know.

Alternatively the WRFIM should be adjusted so that it is consistent with the current Licence – in this case the WRFIM penalty should give company Boards a financial incentive only to set charges in a way that recovers the allowed revenues in each year as defined by the licence with no account taken of previous years. Any net under/over recovery dealt with through the PR19 process.

4. You should state with more clarity the evidence you require us to provide and define what you mean by "normal business risk" in the context of company submissions about the application of the WRFIM.
5. You should clarify in the rulebook that companies can make representations (which Ofwat will in defined circumstances accept) to amend the level of allowed wholesale revenue in the case of material changes in demand (which was clear in Ofwat's statements in our Final Determination about the Hinkley Point nuclear power station) as well as making representations about whether any penalties under the WRFIM should not apply
6. We recommend that you align the indexation rules for allowed wholesale revenues in the WRFIM with that used in the Final Determination and therefore the licence.
7. For the avoidance of doubt you should clarify that the WRFIM is intended to compare Final Determination 2012-13 revenues inflated to outturn using actual (November) RPI with the actual accounting revenues generated during the period. If the intention is to compare outturn values with those projected at the time of the FD then this change should be subject to a separate consultation.
8. We recommend that you clarify the revenue items that are contained within the wholesale revenue allowance and those that are not. To assist this we have provided a table of our regulated revenue streams and where we believe they sit based on the information provided in the Final Determination, the RAGs and the company Licence in an appendix. Please advise us if you disagree with any of our categorisations.

9. You should take account of revenue penalties or rewards incurred in AMP6 through the Menu mechanism when calculating the appropriate AMP7 adjustments - these do not appear in the current spreadsheet calculation and we believe they have been omitted in error.
10. We recommend that you smooth the proposed RCV CIS PR09 adjustment across the AMP7 period in an NPV neutral way so that this adjustment no longer has the qualities of a retrospective adjustment to the RCV.
11. Notwithstanding the above we recommend that all RCV midnight adjustments are in any case smoothed across AMP7 in an NPV neutral way to maintain investor confidence and protect customers' interests.

**Appendix 1 - Revenue Items that Wessex Water considers to be included in the Wholesale revenue caps as set out in the Final Determination at PR14**

Items Explicitly included in wholesale revenue cap	Decision
<b>Wholesale tariff income from provision of water, foul sewerage, surface and highway drainage and trade effluent services</b>	In wholesale revenue cap
<b>Infrastructure charges</b>	In wholesale revenue cap
<b>Contributions for requisitions of new main (including upstream reinforcement)</b>	In wholesale revenue cap
<b>Contributions from developers for requisition of a new sewer (including upstream reinforcement)</b>	In wholesale revenue cap

The table on the following page lists other revenue streams. In cases where we have decided that the item is not included in the revenue cap then we have shown highlighted in red the primary reason why we have chosen to exclude it.

Other items	Is this a non-developer capital contribution?	Is this a Retail Activity?	Is it covered in list of “Excluded charges” in Licence Condition B	Is it apparently excluded in the proposed RAG4 guidance for AMP6	Decision	Comments
<b>Bulk water supply to another water undertaker</b>	N	N	Y		Not in wholesale revenue cap	
<b>Bulk sewerage supply to another sewerage undertaker</b>	N	N	N	Y	Not in wholesale revenue cap	
<b>S45 water supply connection charges (recovery of wholesale element)</b>	N	N	N	N	In wholesale revenue cap	
<b>S45 water supply connection charges (recovery of retail cost element)</b>	N	Y			Not in wholesale revenue cap	
<b>sewerage connection charges – recovery of wholesale cost element</b>	N	N	N	N	In wholesale revenue cap	

Other items	Is this a non-developer capital contribution?	Is this a Retail Activity?	Is it covered in list of “Excluded charges” in Licence Condition B	Is it apparently excluded in the proposed RAG4 guidance for AMP6	Decision	Comments
sewerage connection charges – recovery of retail cost element	N	Y			Outside wholesale revenue cap	
Unmetered building water charges	N	N	Y		Outside wholesale revenue cap	
Standpipe hire charges	N	N	Y		Outside wholesale revenue cap	
Tankered waste charges	N	N	Y		Outside wholesale revenue cap	
Unmetered trough charges	N	N	Y		Outside wholesale revenue cap	
Unmetered standpipe charges	N	N	Y		Outside wholesale revenue cap	
Charges for water from Bowers	N	N	Y		Outside wholesale revenue cap	

Other items	Is this a non-developer capital contribution?	Is this a Retail Activity?	Is it covered in list of “Excluded charges” in Licence Condition B	Is it apparently excluded in the proposed RAG4 guidance for AMP6	Decision	Comments
<b>Fire hydrant maintenance charges</b>	N	N	N	Y	Outside wholesale revenue cap	Excluded as this is rechargeable job as monopoly supplier per RAG4
<b>Fire hydrant installation</b>	Y				Outside wholesale revenue cap	
<b>Charges for repairing damage to company assets</b>	N	N	N	Y	Outside wholesale revenue cap	Excluded as this is rechargeable job as monopoly supplier per RAG4
<b>Charges for diverting company assets (water mains)</b>	N	N	N	Y	Outside wholesale revenue cap	Excluded as this is rechargeable job as monopoly supplier per RAG4
<b>Charges for diverting company assets (sewer mains)</b>	N	N	N	Y	Outside wholesale revenue cap	Excluded as this is rechargeable job as monopoly supplier per RAG4

Other items	Is this a non-developer capital contribution?	Is this a Retail Activity?	Is it covered in list of “Excluded charges” in Licence Condition B	Is it apparently excluded in the proposed RAG4 guidance for AMP6	Decision	Comments
<b>Charges for building over company assets</b>	N	N	N	Y	Outside wholesale revenue cap	Excluded as this is rechargeable job as monopoly supplier per RAG4
<b>Charges for inspection of sewers to be adopted</b>	N	N	N	Y	Outside wholesale revenue cap	Excluded as this is rechargeable job as monopoly supplier per RAG4
<b>Charges to Self-lay organisations</b>	N	N	N	N	In wholesale revenue cap	
<b>Disconnection charges - carrying out</b>	N	N	N	Y	Outside wholesale revenue cap	Excluded as this is rechargeable job as monopoly supplier per RAG4
<b>Disconnection charges - decision and retail admin</b>	N	Y			Outside wholesale revenue cap	
<b>Special meter readings</b>	N	Y			Outside wholesale revenue cap	

Other items	Is this a non-developer capital contribution?	Is this a Retail Activity?	Is it covered in list of “Excluded charges” in Licence Condition B	Is it apparently excluded in the proposed RAG4 guidance for AMP6	Decision	Comments
<b>Meter Testing</b>	N	N	N	Y	Outside wholesale revenue cap	Excluded as this is rechargeable job as monopoly supplier per RAG4
<b>Flow and pressure tests for fire sprinkler systems</b>	N	N	N	N	In wholesale revenue cap	
<b>Provision of plan information on underground infrastructure</b>	N	N	N	N	In wholesale revenue cap	
<b>Charges for installation of meter on unmetered supply</b>	Y				Outside wholesale revenue cap	

Other items	Is this a non-developer capital contribution?	Is this a Retail Activity?	Is it covered in list of “Excluded charges” in Licence Condition B	Is it apparently excluded in the proposed RAG4 guidance for AMP6	Decision	Comments
<b>Non-primary charges to Retailers under Market Codes post 2017 where there is no provision for accredited entity alternatives</b>	N	N	N	Y	Outside wholesale revenue cap	Excluded as this is rechargeable job as monopoly supplier per RAG4
<b>Non-primary charges to Retailers post 2017 under Market Codes where there is provision for accredited entity alternatives</b>	N	N	N	N	In wholesale revenue cap	
<b>Fee for Trade Effluent consent revision</b>	N	N	N	Y	Outside wholesale revenue cap	Excluded as this is rechargeable job as monopoly supplier per RAG4