

February 2016

Trust in water

Update to the PR14 reconciliation rulebook policy document

www.ofwat.gov.uk

ofwat

About this document

In July 2015, as part of the 2014 price review (PR14) we published the [PR14 reconciliation rulebook](#) (the 'rulebook'). We intend the rulebook to provide clarity on how we expect to make adjustments to revenue and RCV to reflect companies' performance during 2015-20, and how we will close out the reconciliation adjustments. It also reflects the approaches set out at in our PR14 final determinations and other relevant policy documents.

Alongside the rulebook, we published the [PR14 reconciliation rulebook policy document](#) (the 'rulebook policy document'). This document explained our approach on the key policy issues associated with the reconciliation calculations. We explained that the PR14 reconciliation rulebook did not include our conclusions in two areas.

- We indicated that we would conclude on the capital expenditure incentive scheme (CIS) reconciliation issue (the 'CIS reconciliation issue') once the Competition and Markets Authority had published its conclusions on Bristol Water's price determination appeal¹.
- We set out for further consultation supplementary considerations to resolve an issue we identified on the consistency between the wholesale revenue forecasting incentive mechanism (WRFIM) and companies' licences.

This document covers our policy decisions on the CIS reconciliation issue and WRFIM. For WRFIM, this document invites companies to confirm their wish to adopt the revised WRFIM formula or a licence modification to us at water2020@ofwat.gsi.gov.uk by 31 March 2016.

We have also updated and reissued the rulebook to address some other minor issues in the previous version of the rulebook and the accompanying spreadsheets.

¹ We consulted on the CIS reconciliation issue in our [reconciliation rulebook consultation](#) in March 2015, pages 50-54.

Contents

1. Overview	3
2. Capital expenditure incentive scheme (CIS)	9
3. Wholesale revenue forecasting incentive mechanism (WRFIM)	21
4. Water trading incentives	29
5. Reconciliation rulebook and spreadsheet revisions	35

1. Overview

1.1 Background and purpose

This document is an update to our [PR14 reconciliation rulebook policy document](#) (the 'rulebook policy document') published in July 2015. We published the rulebook policy document following our [consultation](#) in March 2015.

The rulebook policy document accompanied the [PR14 reconciliation rulebook](#) (the 'rulebook'), which we drafted following our commitment in the PR14 final determinations to publish a rulebook to provide transparency to stakeholders on the reconciliation calculations we will carry out at PR19.

The rulebook published in July 2015 covered the reconciliation calculations for:

- outcome delivery incentives;
- totex menu reconciliation;
- the wholesale revenue forecasting incentive mechanism (WRFIM);
- household retail;
- uncertainty mechanisms;
- PR09 incentives, including the 2014-15 blind year and the capital expenditure incentive scheme (CIS); and
- water trading incentives.

The rulebook policy document set out our conclusions on the above issues with two exceptions.

- The **CIS**, where we indicated that we would only conclude on the CIS reconciliation issue once the Competition and Markets Authority (CMA) published its final conclusions to the Bristol Water appeal. The CMA subsequently published its determination in October 2015. The CMA confirmed that it considered the conclusions on the CIS reconciliation issue were a matter for Ofwat.
- The **WRFIM mechanism**, where we had identified an issue in the consistency between the WRFIM formula and the licence. Specifically, we noted that there could be a conflict between the WRFIM formula and the licence where companies under-recovered revenue. We set out for consultation the options to address the inconsistency.

We cover these two outstanding issues in this update and provide details of revisions for a number of more minor issues around the calculations in the reconciliation rulebook.

Since publishing the rulebook in July 2015, we identified that we need to clarify some detailed points about how the water trading incentives apply to small appointed water companies and third parties. We consulted on these water trading incentive clarifications earlier this year and we include our decisions in this update.

1.2 Conclusions on the CIS reconciliation issue

In our PR14 final determinations, we highlighted an error in the form of an inconsistency in the calculation of the adjustments to be made to the companies' RCVs following the operation of the of the CIS incentive mechanism during the period 2010-15.

We set out the options we considered for addressing the issue in our final determinations. We decided not to make the adjustment in the final determinations, as it risked undermining regulatory predictability, which would not be in the long-term interests of customers. We considered that maintaining confidence in the regulatory framework was important in delivering benefits for customers. We made this decision in the round, taking account of the RCV adjustment that companies received through the 2010-15 true-up and allowing investors a reasonable return. We were clear that we would consult as soon as was practicable on what approach should be adopted in calculating the RCV at PR19.

Consistent with this commitment, we consulted in March 2015 on our preferred option for addressing the CIS reconciliation issue. Under our preferred option, the RCV, from April 2020, would reflect the actual capital expenditure rather than be inflated as a result of the inconsistent use of indexation in the models used to derive the RCV adjustment.

This would lead to a one-off change to the RCV for all companies. At an industry level, this would equate to around 2% of the RCV, but the exact adjustment for each company will vary according to its actual capital expenditure.

Two respondents, the Consumer Council for Water (CCWater) and Bournemouth Water, agreed with our proposal. Four companies agreed with the principle of changing the true up but proposed alternative options, but the majority of companies objected to our preferred approach. However, having fully considered the responses to the consultation, we concluded that the preferred option stated in the consultation is the option that strikes the right balance given our duties under section 2(2A) of the Water Industry Act 1991.

We are satisfied that, on balance, we should favour the consumers' interest over the companies' financial interest as it is reasonable to assume that the PR19 final determinations will take into account the companies' financeability going forward. In addition, we do not consider that the past inconsistency should be resolved in favour of the companies at the expense of customers.

In summary, we consider our preferred approach as set out in the consultation is appropriate for the following reasons.

- It establishes the correct baseline for the RCV going forwards. It avoids a situation where the RCV is inflated as a result of the difference between two inflation indices and so is the option that best represents the interests of customers.
- We consider it is in customers' interest that the effects of the inconsistency do not persist longer than is necessary and so we will address this issue with a one-off adjustment to companies' opening RCVs at the start of the next price control. In addition, companies will have had time to plan for the adjustment, as they have been aware of the possibility that the adjustment will be made to the RCV in 2020 since our consultation in March 2015.
- It does not affect an efficient company's financeability at all or in any material way in the current review period (2015-20). The adjustments will only affect the RCV from the start of the next control period in PR19 when we will be resetting price limits and considering the price determination in accordance with our duties.

Therefore, we confirm that we will adjust the RCV in 2020 to remove the amount remaining in the RCV from the use of inconsistent indexation assumptions in the CIS reconciliation calculations applied at PR14.

We will calculate the adjustments to company RCVs arising from the CIS reconciliation issue when we carry out the true-up calculations for 2014-15. We confirmed in [‘IN 15/17, Expectations for company reporting of 2014-15 actual performance against 2010-15 incentive mechanisms’](#) that we anticipate sharing the draft outcomes of our analysis with companies in summer 2016.

We discuss our conclusions on the CIS reconciliation issue in more detail in chapter 2.

1.3 Conclusions on WRFIM

We introduced the WRFIM at PR14 to replace the PR09 revenue correction mechanism (RCM). We introduced WRFIM to improve companies’ revenue forecasting within the new flexible wholesale revenue controls.

In July 2015, in the [PR14 reconciliation rulebook policy document](#), we explained that we had identified a possible inconsistency between the WRFIM formula and the licence, and we consulted on options to address this inconsistency. We invited views on options, which included a:

- revision to the WRFIM formula for all companies; or
- licence amendment that would ensure the WRFIM could operate as intended.

After careful consideration of the responses to our consultation, **we consider that a licence modification that ensures that the WRFIM can operate as we intended at PR14** would maximise the opportunities for companies to take ownership and accountability for managing cash flows between years for the benefit of customers. Customers in turn are likely to receive smoother movements in bills between years.

This flexibility given to companies to manage revenue in accordance with WRFIM is in line with our direction of travel for PR19, where we want to encourage companies to manage their businesses effectively over the long term. It will also reduce financial pressure where revenue under-recovery is sustained and allow companies to smooth bills more effectively with lower risk of a penalty. The licence amendment would ensure symmetrical treatment of penalties and so remove the potential for perverse incentives.

However, consultation responses suggest it might not be possible to reach an agreement with all companies for a sector-wide licence modification and so the costs of pursuing this are likely to outweigh the benefits. We have concluded that companies should choose their preferred solution between a licence modification and a WRFIM formula change.

We invite companies to confirm their wish to adopt the revised WRFIM formula or a licence modification to us at water2020@ofwat.gsi.gov.uk by 31 March 2016. We set out the proposed licence text in section 3.1.

For companies that indicate their acceptance of the licence modification, we will then proceed to a formal statutory consultation on the licence amendment as soon as practicable. In any case, we will have to have the amendments in place in time for companies to carry out their billing runs for 2017-18 to allow for the true-up of revenue over- or under-recovery from 2015-16.

We discuss our conclusions on WRFIM in further detail in chapter 3.

1.4 Conclusions on water trading incentives

We introduced water trading incentives at PR14 following extensive consultation during 2012 and 2013 on the main aspects of the incentives. We also consulted on the operation of the incentives through our consultation on the PR14 reconciliation rulebook in March 2015. Since we published the rulebook in July 2015, we identified that we had not clarified some detailed points about how the water trading incentives apply to small appointed water companies and third parties. We consulted on these clarifications earlier this year.

Our proposals covered the application of water trading incentives to eight specific transactions detailed in chapter 4. We received five responses to the consultation – all from large appointed water companies. One respondent made no comment and the other four supported our clarifications about how the water trading incentives apply to transactions 2-8 (defined in chapter 4).

In relation to transaction 1 – an export from a large appointed water company to a small appointed water company – we had proposed that no export incentive would apply, as we did not have any evidence of artificial barriers to trading that have prevented new appointee sites from receiving supplies.

However, Dŵr Cymru identified that if a large appointed water company exported water to a small appointed water company in another large company's appointed area, this could constitute a genuine water trade. While none of the existing 42 new appointee sites are served in this way, we considered that such a case could be similar to a water trade between large appointed water companies.

We consider that for consistency it would be appropriate for the export incentive to apply in such a case. Therefore, we have decided that in the case of an export from a large appointed water company to a small appointed water company the export incentive could apply in specific circumstances.

We discuss our conclusions on the clarifications of the water trading incentives in more detail in chapter 4.

1.5 Other changes to the rulebook

There are no changes to the calculations set out in the reconciliation rulebook as a result of our decision on the CIS reconciliation issue. But there are some minor changes to the reconciliation rulebook as a result of our decision on WRFIM. We provide details of the WFRIM changes in this update to the PR14 reconciliation rulebook policy document.

We have also resolved a number of minor issues that respondents identified in the rulebook and accompanying spreadsheets. We set these issues out in this update, and we have published a revised version of the reconciliation rulebook and the accompanying spreadsheets.

We summarise the changes in chapter 5.

2. Capital expenditure incentive scheme (CIS)

2.1 Background

We introduced the CIS at the 2009 price review (PR09) for capital expenditure (capex) to reward both accurate business planning at PR09 and cost outperformance in 2010-15.

Under the CIS, each company proposed a forecast of its capital expenditure over 2010-15, as part of the price review process. We determined a baseline expenditure for each business plan reflecting the outputs and outcomes each company had to deliver and an understanding of industry average efficiency.

The mechanism allows the company to recover, in allowed revenues, its actual capital expenditure plus or minus a reward or penalty. A company is rewarded if it spends less than our baseline expenditure, while it is penalised if its actual capex exceeds this baseline. The size of these rewards and penalties depend on the expenditure forecast chosen and how the companies' actual expenditure compares with this forecast.

At PR09, we explained that we would reflect actual capital expenditure in the RCV at the start of the next price control period. Thus, the CIS mechanism gives rise to two adjustments.

- **CIS RCV adjustment.** This ensures that total actual capital expenditure is included in the RCV. To do this, the capex allowed in the PR09 final determinations is subtracted from the RCV, and the actual expenditure is added back.
- **CIS revenue adjustment.** This reverses any return earned on capex, which was over-funded by the PR09 settlement or, conversely, allows additional revenue to true-up capex under-funded by the PR09 settlement.

We set out in detail our CIS methodology and process both within the main PR09 methodology statement and as part of the associated PR09 final determination documents.

Following our final determinations at PR09, our view of the way that the CIS should operate was the subject of correspondence with the sector and two information notices (IN 11/08 and IN 12/08). Among other things, IN 12/08 provided an illustrative example of the CIS and a flowchart showing the step-by-step mechanics of the CIS reconciliation. In January 2013, we published a CIS spreadsheet model, which followed the approach in the flowchart. This model formed the basis of the CIS feeder models that were used during our risk-based review at PR14, published in April 2014 and used for the draft determinations.

One respondent to the draft determinations (Severn Trent Water) set out two alternative approaches to the CIS reconciliation that would have resulted in adjustments that were favourable to all companies. We described an alternative approach, which would have resulted in lower opening RCVs across all companies.

We set out the options we considered for addressing the issue in our PR14 final determinations. We decided not to make the adjustment in the final determinations, as it risked undermining regulatory predictability, which would not be in the long-term interests of customers. We considered that maintaining confidence in the regulatory framework was important in delivering benefits for customers. We made this decision in the round, taking account of the RCV adjustment that companies received through the 2010-15 true-up and allowing investors a reasonable return.

We said that for the period beyond 2015-20, we would engage with stakeholders and consider whether the existing approach to adjusting for inflation was in the long-term interests of customers. We said that if we considered an adjustment appropriate, any change would have a prospective effect only, and would be applied industry-wide.

We subsequently consulted on the CIS reconciliation issue in March 2015. The consultation set out three options and noted they could potentially all be consistent with the original policy intent in the PR09 documentation. We explained the preferred option would remove the inconsistency between the different adjustments and avoid a situation where the RCV was inflated as a result of the difference between two inflation indices. The preferred approach would lead to a one-off correction to the RCV at the start of AMP7. We confirmed that our preferred approach was consistent with our statutory duties.

The adjustment we proposed would affect all companies, and would be in proportion to each company's PR09 capital expenditure allowance. At the industry level, we calculated that the potential adjustment to the RCV would be around 2% of the RCV, which would be set in 2020.

In July 2015, we published the reconciliation rulebook, which did not include our conclusions on the CIS reconciliation issue. We said that the CMA was considering Bristol Water's appeal of its price determination. While the CMA had provisionally decided not to address the CIS reconciliation issue as part of the appeal, we considered it would be appropriate to conclude on the CIS reconciliation issue once the CMA's process had ended.

The CMA published its final determination in October 2015. It said that it was prudent to allow Ofwat to conduct its industry-wide process (on the CIS reconciliation issue) without the CMA's intervention.

In this update to the rulebook, we set out our decision on the CIS reconciliation issue.

2.2 Consultation responses

We received 19 responses to the treatment of inflation in the CIS RCV adjustment. The responses came from all 18 companies and CCWater.

CCWater was supportive of our proposal. It said:

“... in the interests of maintaining stability in the sector, which benefits customers, the RCV should be an accurate reflection of the value of a company, so we accept Ofwat's proposed reconciliation.”

Bournemouth Water agreed with the proposition. South West Water agreed with the proposition as long as we confirmed that the differential use of inflation was a technical error rather than an inconsistency.

All other companies raised issues with or objections to our preferred approach.

The main objections to our proposal can be summarised as follows.

- **Reopening the PR14 package.** The adjustment would re-open the PR14 package that companies had accepted in the round.
- **Expectations.** Ofwat had set expectations during the 2010-15 period on how the CIS adjustment would be calculated, which differs from the final proposal.
- **Process.** Ofwat did not follow an appropriate process as the final determinations stated that the correction would be slight, and Ofwat had not set out the scale of the issue until the March reconciliation rulebook consultation.
- **Retrospective.** The adjustment is retrospective as it is adjusting in PR19 for something that happened in 2010-15.
- **AMP6 financeability.** The adjustment will impact on AMP6 financeability.
- **Compelling case.** Ofwat did not make a compelling case for the adjustment.
- **Investor confidence.** The adjustment is not in the best interests of customers as it could increase investors' perceptions of uncertainty over the regulatory framework.

We summarise all the key issues raised in the responses to the consultation and our comments in table 1 below. The responses to the consultation are available [on our website](#).

Table 1: Summary of responses to the consultation and our response

Issue that companies raised	Respondents	Our response
<p>Reopening the PR14 package. The adjustment would re-open the PR14 package that companies had accepted in the round.</p>	<p>Anglian, Dŵr Cymru, Northumbrian, Severn Trent, Southern, Thames, United Utilities, Wessex, Yorkshire, Affinity, Portsmouth, South East, South Staffordshire, Sutton and East Surrey</p>	<p>We do not consider that the adjustment would re-open the PR14 package. No element of the PR14 price control is affected. The CMA chose not to address the CIS reconciliation issue in its redetermination of Bristol Water’s appeal, and was content to leave the matter to our consultation.</p> <p>We indicated in the PR14 final determinations that alternative approaches could have been taken to the CIS reconciliation. In particular, we indicated that: “... if change were required there is an alternative approach [...]. This alternative approach would have resulted in lower opening RCVs across all companies in April 2015.” We therefore signalled that we would consult early in 2015-20 on whether the approach adopted was in the long-term interests of customers and on how we approach any adjustment to the RCV at PR19 as a result of indexation. We said: “Any change would have a prospective effect only, and would be applied industry-wide.”</p> <p>Our final position is consistent with this statement.</p>
<p>Ofwat had set expectations on the way that the CIS adjustment was going to be calculated.</p>	<p>Severn Trent, Southern, Thames, United Utilities, Dee Valley, South East, South Staffordshire, Sutton and East Surrey</p>	<p>While we had published the spreadsheets for the CIS true-up calculations ahead of the PR14 methodology, we only fully appreciated the issue with the adjustment in the lead-up to the final determinations.</p> <p>We decided not to make the adjustment in the final determinations, as it risked undermining regulatory predictability, which would not be in the long-term interests of customers and might undermine trust and confidence in the regulatory framework. We considered that maintaining confidence in the regulatory framework was important in delivering benefits for customers. For 2015-20, we made our decision in the round, taking account of the RCV adjustment that companies received through the 2010-15 true-up and allowing investors a reasonable return. We were also clear that we would consult shortly after final determinations on how we approach any adjustment to the RCV at PR19 as a result of indexation.</p> <p>There is no legitimate expectation that a regulator will act inconsistently with its statutory obligations or maintain a policy which it considers no longer furthers the objectives in section 2(2A) of the Water Industry Act 1991.</p>

Issue that companies raised	Respondents	Our response
<p>Ofwat did not follow an appropriate process as the final determinations stated that the correction would be slight.</p>	<p>Northumbrian, Severn Trent, Southern, Thames, Affinity, South East</p>	<p>We articulated the issues associated with the treatment of indexation in the CIS RCV adjustment in the final determinations. We are aware that a number of companies were able to calculate the impact on them of the possible alternative approach we referred to in the final determinations, which would have resulted in lower opening RCVs across all companies in April 2015.</p> <p>The issue with the CIS adjustment was highlighted in documented phone calls to company Chief Executives made at the time of the final determinations.</p>
<p>The adjustment is retrospective as it is adjusting in PR19 for something that happened in PR09.</p>	<p>Severn Trent, Southern, Thames, Wessex, Yorkshire, Dee Valley, Portsmouth, South East, Sutton and East Surrey</p>	<p>We indicated in the PR14 final determinations that alternative approaches could have been taken to the CIS reconciliation. In particular, we indicated that "... if change were required there is an alternative approach [...]. This alternative approach would have resulted in lower opening RCVs across all companies in April 2015." We therefore signalled that we would consult early in 2015-20 on whether the approach adopted was in the long-term interests of customers. We said: "It will be appropriate for us to consult shortly on how we approach any adjustment to the RCV at PR19 as a result of indexation. If we consider an adjustment would be appropriate, there would be no need to adjust retrospectively for the revenues received in the interim. These have been correctly set in this price control review, based on Ofwat's existing approach to inflation. Any change would have a prospective effect only, and would be applied industry-wide."</p> <p>We are fulfilling the commitment we made in our final determinations not to make any retrospective changes. The adjustment is not retrospective as it affects the RCV in 2020 only. We are also not adjusting for the return and RCV run-off that companies have received during 2015-20.</p>

Issue that companies raised	Respondents	Our response
<p>The adjustment is not in the best interests of customers as it could increase investors' perceptions of uncertainty over the regulatory framework.</p>	<p>Northumbrian, Severn Trent, Southern, Thames, United Utilities, Wessex, Affinity, Dee Valley, South East, South Staffordshire, Sutton and East Surrey</p>	<p>We do not consider that this adjustment on its own should increase investor perceptions of uncertainty with the regulatory framework, as this was something that we stated we would consider in the final determinations and we are now following through.</p> <p>In addition, Moody's² confirmed in September 2015 that it did not consider the adjustment to be credit negative.</p> <p>Moody's said: "An adjustment that goes back further than the preceding regulatory period and rectifies a true-up adjustment determination as part of a final determination is unusual. However, Ofwat indicated the mistake and its correction in its final determination documents. The adjustment is also relatively minor and corrects a genuine error. While, therefore, in this context not a credit negative, we would generally view any retrospective regulatory adjustments as credit negative for the sector, particularly if they are larger scale."</p>
<p>The adjustment impacts on AMP6 financeability.</p>	<p>Severn Trent, Southern, Thames, Wessex, Dee Valley, South East</p>	<p>We do not consider the adjustment will impact on the financeability of an efficient company in AMP6 at all or in any material way as it will not affect the RCV or financial ratios in AMP6 as price limits have already been set for 2015-20.</p> <p>We acknowledge that the adjustment could impact on the shadow RCV in AMP6 where it takes account of forecast adjustments. However, even if we were to adjust gearing within AMP6 to take account of the prospective CIS adjustment, then we calculated that all companies would still have gearing consistent with a rating well within the investment grade.</p> <p>The adjustment will occur at the start of AMP7 and it is one of a number of adjustments that will be made to the RCV at PR19. We will assess AMP7 financeability as part of the price setting approach at PR19 in line with our statutory duties.</p> <p>The key financial ratio that could be affected by the CIS adjustment is gearing, which is one of the core ratios used by investors and credit rating agencies. As we set price limits by</p>

² Moody's stable outlook – calm waters ahead of the storm? September 2015.

Issue that companies raised	Respondents	Our response
		<p>reference to a notional capital structure, and as we set gearing at the start of each control period, the adjustment will not impact on notional financeability at all or in any material way.</p> <p>We acknowledge that for some companies with highly geared structures, the prospective CIS adjustment might limit their ability to take on more debt. However, consistent with our long-held policy on capital structure, we consider this is a matter the highly geared companies must manage for themselves.</p>
<p>Ofwat has not made a compelling case for the adjustment.</p>	<p>Anglian, Northumbrian, Severn Trent, Southern, Thames, United Utilities, Affinity, Bristol, South East, Sutton and East Surrey</p>	<p>We have set out the issues associated with the treatment of indexation. The preferred approach in our March 2015 consultation is the only option that avoids a situation where the RCV is inflated as a result of the difference between two inflation indices and so it is the option that best represents the interests of customers.</p> <p>Taking account of responses to the consultation, we consider the approach we are now adopting is appropriate. It is the only option that ensures that actual capital expenditure is included in companies' RCVs and is an approach that strikes the right balance (and is fair to consumers) given our duties under section 2(2A) of the Water Industry Act 1991.</p>
<p>An alternative approach should have been used which would increase rather than reduce the CIS adjustment.</p>	<p>Bristol</p>	<p>We do not consider that the approach Bristol Water proposed is appropriate as it would give companies more than their actual capex and so would be inconsistent with the objectives of the CIS mechanism that expenditure added to the RCV should reflect actual expenditure.</p> <p>Bristol Water's proposed approach would also perpetuate a situation where the RCV is inflated as a result of the difference between two inflation indices, a situation which we consider does not further our objectives under section 2(2A) of the Water Industry Act 1991 in a way that is fair to consumers.</p>
<p>The CIS adjustment should be smoothed over AMP7 rather than be applied in full through a one-off adjustment to the opening RCV for the 2020-25 period.</p>	<p>Thames, Wessex, South Staffordshire</p>	<p>We consider that the approach which leads to an RCV adjustment in March 2020 is reasonable and takes account of the interests of customers. Treating this as an adjustment at the start of AMP7 (as a 'midnight adjustment') ensures the effects do not persist longer than is necessary.</p>

Issue that companies raised	Respondents	Our response
<p>Agree to the treatment if Ofwat agrees it was an error/needs to emphasise the special circumstances so that other elements of the determination will not be revisited.</p>	<p>South West, United Utilities</p>	<p>We have restated the issue in section 2.1 of this document. The adjustments are to address an inconsistency in our calculations and are necessary to make sure the CIS adjustments ensure companies' RCVs reflect actual capex rather than adjustments that have been inflated. No other aspect of our PR14 final determinations is affected.</p>
<p>Urge Ofwat to consider the implications for enhanced companies and that the 'do no harm' principle should be extended to the CIS adjustment.</p>	<p>Affinity</p>	<p>Both Affinity Water and South West Water were enhanced companies at PR14. We confirmed at PR14 that the 'do no harm' principle did not extend to all policy areas and did not extend to the reconciliation calculations for true-up of legacy incentive mechanisms.</p>
<p>No amendment should be made to the PR14 final determinations. The adjustment should be made only to the RCV midnight adjustment at PR19 after deducting the RCV run-off for 2015-20.</p>	<p>Northumbrian</p>	<p>This is consistent with our final position.</p>
<p>Agreed with our proposal</p>	<p>Bournemouth</p>	<p>This is consistent with our final position.</p>

2.3 Our decision

Two respondents (CCWater and Bournemouth Water) agreed with our proposal. Having considered fully the responses to the consultation, we conclude that the preferred option stated in the consultation is the option that strikes the right balance given our duties under section 2(2A) of the Water Industry Act 1991.

Where companies have raised objections to our preferred approach, we have carefully considered their representations. In summary, we consider our preferred approach is appropriate for the following reasons.

- It establishes the correct baseline for the RCV going forwards. It avoids a situation where the RCV is inflated as a result of the difference between two inflation indices and so is the option that best represents the interests of customers.
- We consider it is in customers' interests that the effects of the inconsistency do not persist longer than is necessary, and so we will address this issue with a one-off adjustment to companies' opening RCVs at the start of the next price control. In addition, companies will have had time to plan for the adjustment as they have been aware of the possibility that the adjustment will be made to the RCV in 2020 since our consultation in March 2015.
- It does not impact on an efficient company's financeability at all or in any material way in the current review period (2015-20). The adjustments will only affect the RCV from the start of the next control period in PR19 when we will be resetting price limits and considering the price determination in accordance with our duties.

Therefore, we confirm that **at PR19 we will adjust the RCV for March 2020 to remove the amount remaining in the RCV from the use of inconsistent indexation assumptions in the CIS reconciliation calculations applied at PR14.**

Our final decision is consistent with the approach set out in the reconciliation rulebook. No changes are necessary to the reconciliation rulebook calculations as a result of this decision on CIS.

We consider that this approach is consistent with our assessment criteria based on our statutory duties, which was included in the [March 2015 consultation](#) at appendix 1 and restated below.

Table 2: Assessment of options for the CIS adjustment

Criteria	Option 1: do nothing	Option 2: do something
Customer benefits		
Company financeability		
Consistency with final determinations and other relevant documents		
Risk of perverse incentives		
Company ownership and accountability		
Consistency with other reconciliation tools		
Straightforward and clear to implement		
Preferred option	x	✓

2.4 Next steps

We stated a provisional view of the adjustments in a [spreadsheet](#) that accompanied the consultation. The adjustment was calculated based on actual capital expenditure for 2010-14 and forecast expenditure for 2014-15 that was used in the PR14 final determinations. The adjustments stated were provisional in lieu of the final true-up calculations for actual expenditure incurred in 2014-15.

We will calculate the actual adjustments to company RCVs arising from the CIS reconciliation issue when we carry out the true-up calculations for 2014-15. We confirmed in '[IN 15/17, Expectations for company reporting of 2014-15 actual performance against 2010-15 incentive mechanisms](#)' that we anticipate sharing the draft outcomes of our analysis with companies in summer 2016.

We noted in our [March 2015 consultation](#) and the [PR14 reconciliation rulebook policy document published in July 2015](#) that there remain some practical issues arising from the development of the construction output price indices (COPI) by the Office for National Statistics (ONS) and the associated suspension of the COPI index. We confirm that our approach to COPI in the true-up calculations will remain as outlined in the reconciliation rulebook – that is, we should update COPI in 2016. We may need to make an adjustment to convert from any new COPI index to one that is consistent with the COPI index used at PR14 (for example, if there is a series break in COPI).

We will include full details of the approach we adopt on COPI when we finalise the reconciliation calculations for CIS and other incentive mechanisms as indicated in IN 15/17, and invite views from companies and other interested stakeholders at that time.

3. Wholesale revenue forecasting incentive mechanism (WRFIM)

3.1 Background

We introduced WRFIM at PR14 to replace the PR09 revenue correction mechanism (RCM). We introduced WRFIM to improve companies' revenue forecasting within the new flexible wholesale revenue controls.

We consulted on WRFIM in our '[Consultation on the wholesale revenue forecasting incentive mechanism for AMP6](#)', published in April 2014. We further clarified our approach in '[Draft price control determination notice: technical appendix A6 – risk and reward](#)', and responded to companies' concerns on the mechanism. We finalised our approach in '[Final price control determination notice: policy chapter A7 – risk and reward](#)', taking account of company responses to the April consultation and company representations following the draft determinations.

The purpose of the mechanism is to reduce the impact of deviations on customer bills arising from revenue forecasting deviations by:

- adjusting companies' allowed revenues each year to take account of differences between actual and projected revenues; and
- incentivising companies to avoid revenue forecasting errors by applying a penalty to variations that fall outside the set revenue flexibility threshold.

In the rulebook published in July 2015, we explained we had identified an issue on the consistency between the WRFIM formula and the licence.

In summary, the licence allows price controls to limit the annual change in allowed revenue and does not explicitly reference the WRFIM formula, or any adjustment to revenues to make up for previous under- or over-recovery. When a company under-recovers in year $t-2$, the WRFIM uplifts the allowed revenue for year t , taking into account that previous under-recovery.

This means that the company is incentivised to make up the previous under-recovery and collect more revenue than allowed by the limit set out in the price control. If the company did not make up this previous under-recovery, then it could be liable for a penalty under the WRFIM formula. We do not consider that the licence prevents a company that had over-recovered revenue from choosing to set prices below the price control limit to offset this previous over recovery.

Therefore, in our July 2015 rulebook we consulted on alternative options to address the inconsistency between the licence and the WRFIM formula. We invited views on the following three options.

- **Option 1:** a revised WRFIM formula for all companies that would remove the penalty on companies if they do not make up previous under-recovery. The formula would allow for reconciliation of over- and under-recovery subject to a time value for money adjustment.
- **Option 2:** allow companies to choose between a licence amendment (and the original WRFIM formula) or no change to the licence (and the use of a revised WRFIM formula stated in option 1).
- **Option 3:** only introduce a sector-wide licence modification if all companies agree to the proposed change.

We provided an illustrative example of a possible amendment to condition B in the licence, which we restate below.

“For the avoidance of doubt, sub-paragraph [8.1/9.1³] does not prevent the Appointee from levying charges to recover a Relevant Shortfall in a Relevant Charging Year regardless of the limit on the change in revenue allowed to the Appointed Business in respect of the Wholesale Activities concerned. For the purposes of this sub-paragraph:

(a) a “Relevant Charging Year” is a Charging Year in the period from 1 April 2017 to 31 March 2020; and

(b) a “Relevant Shortfall” is any positive amount (RFIMt) calculated for the Relevant Charging Year in accordance with the Wholesale Revenue Forecasting Incentive Mechanism (WRFIM) formula published by the Water Services Regulation Authority in December 2014.

³ The lower number refers the relevant sub-paragraph of licence condition B for water only companies and the higher number refers to the relevant sub-paragraph of licence condition B for water and sewerage companies.

This sub-paragraph shall cease to have effect on 1 April 2020.”

The consultation closed on 10 August 2015.

We have published the individual responses on this issue alongside the responses to the initial consultation⁴.

3.2 Consultation responses

We received 14 responses in relation to the revised WRFIM formula and proposed licence modification. Responses also focused on other matters related to the WRFIM. All responses came from companies.

In summary, the focus of responses to our proposal was as follows.

- **Seven companies expressed support for option 2 (the option to choose between a licence amendment or revision to the WRFIM formula).** Companies suggested that this option is the only solution that facilitates the operation of the WRFIM as was envisaged at the time that final determinations were accepted, without making this conditional upon the individual decisions taken by other companies. In addition, respondents suggested that given the time-limited impact on company licences, there is little downside in allowing companies to choose between the licence amendment proposed and the use of the revised (asymmetric) WRFIM formula.
- **Five companies expressed support for option 3 (a sector-wide licence modification).** The argument is that the current licence condition B should be applied symmetrically in period, and since it does not allow for adjustments to make up revenue under-recovery in previous years, there should be an expectation for adjustments to revenue for over-recovery to be symmetrical.
- **Two companies did not have a clear preference on the three consulted options.**

⁴ <http://www.ofwat.gov.uk/consultation/the-pr14-reconciliation-rulebook-policy-document/>.

We summarise all the key issues raised in the responses to the consultation and our high-level response in table 3 below. We also set out other related issues on the WRFIM raised in response to the consultation and our response. The responses to our consultation are available [on our website](#).

Table 3: Summary of responses to the consultation and our response

Issue that companies raised	Respondents	Our response
Support for option 2. Allow companies to choose between a licence amendment (and the original WRFIM formula) or no change to the licence (and the use of a revised WRFIM formula).	Dee Valley, South East, Southern, Thames, Wessex, Yorkshire	We set out in section 3.3 that a licence modification maximises the opportunities for companies to take ownership and accountability for managing cash flows between years for the benefit of customers. A licence modification is in line with our direction of travel for PR19 that allows companies to manage their business effectively over the long term.
Support for option 3. Only introduce a sector-wide licence modification if all companies agree to the proposed change.	United Utilities, Sutton and East Surrey, South Staffordshire, Severn Trent, South West	We welcome responses from companies that are supportive of the licence modification.
No clear preference on the three consulted options.	Bristol, Dŵr Cymru	
Corrections to the WRFIM spreadsheet in reconciliation rulebook consultation.	Anglian, United Utility, Thames	We have amended the WRFIM spreadsheet. The amendments are stated in chapter 5.
Text of proposed licence modification , including the explicit reference to the provision ceasing to have effect on 1 April 2020.	Sutton and East Surrey, South East	We propose that we retain the proposed text and condition on expiry date. A WRFIM licence modification would be a time-specific provision (specifically applying to the 2017-20 period). Therefore, we consider that it is appropriate to provide for it to cease to have effect (and so be removed from licence condition B) at the end of the relevant period.

Issue that companies raised	Respondents	Our response
<p>Licence text should exclude the words “for the Relevant Charging Year” in the definition of “Relevant Shortfall”.</p>	South East	<p>The effect of the WRFIM formula is that RFIM calculated for any charging year (t) is the difference between the allowed and recovered revenue in charging year t-2. So, for example, the RFIM calculated for 2017-18 (the first Relevant Charging Year) is the difference between allowed and recovered revenue in 2015-16.</p> <p>For this reason, we do not consider the text “for the Relevant Charging Year” should be deleted.</p>
<p>K abatements and social tariffs. There should be no new limitations or disincentives placed on companies to under-recover revenue from wholesale revenue controls where this in customers’ interests, such as an abatement of K.</p>	South West	<p>We welcome companies’ commitments that are in customers’ interests, and agree that such initiatives should not be disincentivised or penalised. Therefore, we confirm that the impact on the wholesale business will follow similar principles to the RCM in PR09:</p> <p>For voluntary profit sharing where the revenue loss is funded by companies’ shareholders (for example, the K abatement in 2014-15) and the company will not recover the shortfall in future, this voluntary revenue loss will be excluded from the revenue deviation in WRFIM. The actual amount of collected revenue will be reported in RAG pro forma 2I – row 38 columns C and D, as well as the amount of the revenue loss. This can then be taken into account for the purpose of WRFIM adjustments. Therefore, no penalty will be applicable to it and this shortfall will not be able to be recovered two years later.</p> <p>For ‘cost neutral’ schemes where other customers cross-subsidise the revenue loss, this revenue loss will be included in the revenue deviation in WRFIM. The actual amount of collected revenue will be reported in RAG pro forma 2I – row 38 columns C and D. It will be subject to penalties and where applicable it will be recoverable two years later.</p>

Issue that companies raised	Respondents	Our response
<p>Back-billing incentive. The absence of an incentive to back-bill is not in customers' interests.</p>	<p>Severn Trent</p>	<p>We confirm the WRFIM will apply as stated in the PR14 final determinations with no back-billing incentive, as:</p> <ul style="list-style-type: none"> • good companies should manage to identify and bill customers to ensure that the impacts on their customers are minimised and managed; • we have removed the back-billing incentive as part of a broader programme of regulatory change. Companies have a financial incentive in this control period to identify and bill customers through the household retail price control as they receive revenues on a per customer basis; • the new company monitoring framework is a broad reputational tool to incentivise companies to promote trust and confidence in the sector and their actions in this control period will be taken into account in their assessment in PR19; and • including additional incentives would be inconsistent with our final determinations.
<p>Early publication of wholesale charge. Concerns about the proposal, in section 9.3 of the retail market opening consultation, that wholesalers publish "by July each year" indicative wholesale charges for the following year, which would only be adjusted for any discrepancy between the forecast and actual RPI.</p>	<p>Dŵr Cymru</p>	<p>We will consider this issue as part of a separate wholesale charging consultation. We propose not to change the WRFIM, as:</p> <ul style="list-style-type: none"> • no evidence is provided on the reduction in the confidence of early published 'indicative' wholesale charges or the significance of the impact; • although a later forecast might be more accurate, if the impact is marginal, an early publication of wholesale charges' benefit to the retail market may outweigh its risk to the accuracy of forecast; and • the representation process within the WRFIM can mitigate the risk to water companies in exceptional cases where new information before charges are implemented causes significant changes in the revenue forecast.

3.3 Our decision

We consider that a licence modification that ensures that the WRFIM can operate as intended at PR14 will maximise the opportunities for companies to take ownership and accountability for managing cash flows between years for the benefit of customers. Customers in turn are likely to receive smoother movements in bills between years.

The flexibility given to companies to manage revenue in accordance with the WRFIM is in line with our direction of travel for PR19, where we want to encourage companies to manage their businesses effectively in the long term. The flexibility will reduce financial pressure where revenue under-recovery is sustained and allow companies to smooth bills more effectively with lower risk of a penalty. The licence would allow symmetrical treatment of penalties and so remove the potential for perverse incentives.

However, consultation responses suggest it might not be possible to reach an agreement with all companies for a sector-wide licence modification and so the costs of pursuing this are likely to outweigh the benefits. This suggests that consultation option 3 may not be practical.

Therefore, we have concluded to pursue **option 2**, which allows each company to choose their preferred solution and gives them the flexibility to choose the option that best suits their business and the interests of their customers.

We consider that this approach is consistent with our assessment criteria, which takes account of our statutory duties, stated below.

Table 4: Assessment of options for the WFRIM

Criteria	Option 1: revised WRFIM formula	Option 2: company choice	Option 3: sector-wide licence modification
Customer benefits			
Company financeability			
Consistency with final determinations and other relevant documents			
Risk of perverse incentives			
Company ownership and accountability			
Consistency with other reconciliation tools			
Straightforward and clear to implement			
Preferred option	x	✓	x

For the reasons set out in the consultation and above, we confirm that **we will adopt option 2 for the PR14 reconciliation – that is, we will allow companies to choose between a licence amendment (and the original WRFIM formula) or no change to the licence (and the use of a revised WRFIM formula).**

3.4 Next steps

We encourage companies to opt to accept the licence modification as we consider this allows them to best manage movements in customer bills. The licence modification would create flexibility for companies, in line with our direction of travel for PR19, to manage their business effectively over the long term. We set out the draft wording for a licence modification in section 3.1. We set out in table 3 our response to the initial comments we received on the drafting. **We invite companies to confirm their wish to adopt the revised WRFIM formula or a licence modification by 31 March 2016.** Companies should confirm this to us at water2020@ofwat.gsi.gov.uk.

For companies that indicate their acceptance of the licence modification, we will then proceed to a formal statutory consultation on the licence amendment as soon as practicable, and in any case we have to have the amendments in place in time for companies to carry out their billing runs for 2017-18 to allow for the true-up of revenue over- or under-recovery from 2015-16.

4. Water trading incentives

4.1 Background

In the rulebook published in July 2015, we set out our approach to applying the export incentive, applying the import incentive and applying inflation, time value of money and taxation to the water trading incentives.

Following the publication the rulebook, we identified that we needed to clarify how the water trading incentives apply to certain transactions between large appointed water companies, small appointed water companies and third parties⁵. We carried out a short consultation in relation to these clarifications between 18 January and 3 February 2016. In our consultation, we proposed clarifications of the application of the water trading incentives to the eight instances covered in table 5 below. We provided a summary explanation of our reasons for our preferred approach.

Table 5: Proposed clarifications to the application of the trading incentives in our consultation

Description of transaction and whether an incentive applies	Reason for proposed approach to whether a water trading incentive applies
<p>1. An export from a large appointed water company to a small appointed water company.</p> <p>No export incentive applies</p>	<p>Almost all new water appointee sites are served by a bulk supply export from the local large appointed water company⁶. The motivation for the export incentive was to overcome the artificial barriers to water trading between large appointed companies. We do not have evidence of artificial barriers to trading that have prevented new appointee sites from receiving supplies. Therefore, at this stage we do not propose to extend export incentives to these circumstances. We propose that the export incentive does not apply to a large appointed water company exporting water to a small appointed water company (as defined in this footnote⁷).</p>

⁵ The distinction between a large appointed water company and a small appointed water company in relation to the water trading incentives is based primarily on the difference in price control regulation, which is proportionate to the relative size of the businesses. Large appointed water companies are subject to detailed price control regulation (including separate retail and wholesale price controls), but small appointed water companies are currently subject to relative price controls or, in the case of Cholderton and District Water Company, a simplified revenue control.

⁶ Forty-one out of forty-two new appointee sites are served by a water export from the local large appointed water company. The remaining water appointee site self-supplies itself with water.

⁷ By small appointed water companies, we mean water undertakers that, because of their size, are not subject to full price controls. This currently means Cholderton and District Water Company and

Description of transaction and whether an incentive applies	Reason for proposed approach to whether a water trading incentive applies
<p>2. Import to a small appointed water company from a large appointed water company.</p> <p>No import incentive applies</p>	<p>Almost all new appointee sites are served by a bulk supply import to the small appointed water company. As in (1) above we do not have evidence of artificial barriers to these arrangements and in any case the small appointed companies typically have incentives for efficiency created by their relative price controls. We therefore propose that the import incentive does not apply to a small appointed water company importing water from a large appointed water company.</p>
<p>3. Import to a large appointed water company from a small appointed water company.</p> <p>Import incentive applies⁸</p>	<p>Large appointed water companies are eligible for an import incentive for an import of water from another large appointed water company. We consider our water trading incentives would unintentionally bias the market in favour of large appointed water companies if the import incentive did not also apply to imports from small appointed water companies to large appointed water companies. We propose that a large appointed water company is eligible for an import incentive for an import of water from a small appointed water company.</p>
<p>4. Export from a small appointed water company to a large appointed water company.</p> <p>No export incentive applies</p>	<p>As noted above, small appointed water companies are not subject to our full price control regulation and are typically able to retain all the profits from an export to a large appointed water company. Introducing export incentives would also add unnecessary complexity to new appointees' simplified price controls. As a result, we propose that the export incentive does not apply to an export from a small appointed water company to a large appointed water company.</p>
<p>5. Import to a small appointed water company from a third party.</p> <p>No import incentive applies</p>	<p>We do not have evidence of artificial barriers to small appointed water companies importing water from third parties. In any case, the small appointed companies typically have incentives for efficiency created by their relative price controls. Therefore, we propose that the import incentive does not apply to a small appointed water company importing water from a third party.</p>

five new appointees: Albion Water, Independent Water Networks, Peel Water Networks, SSE Water and Veolia Water Projects.

⁸ A water company needs to submit its trading and procurement code to Ofwat for approval ahead of PR19 if it wants to claim an export and/or import incentive at PR19. So far, we have publicly consulted on one trading and procurement code: <http://www.ofwat.gov.uk/consultation/trading-and-procurement-code-dwr-cymru/>. The water company will have to show that its import complies with an Ofwat-approved trading and procurement code for an import incentive to be paid at PR19.

Description of transaction and whether an incentive applies	Reason for proposed approach to whether a water trading incentive applies
<p>6. Export from a small appointed water company to a third party.</p> <p>No export incentive applies</p>	<p>Small appointed water companies are not subject to our full price control regulation and are typically able to retain all the profits from an export to a third party. Introducing export incentives would also add unnecessary complexity to new appointees' simplified price controls. As a result, we propose that the export incentive does not apply to an export from a small appointed water company to a third party.</p>
<p>7. Import to a large appointed water company from a third party.</p> <p>Import incentive applies⁹</p>	<p>Large appointed water companies are eligible for an import incentive for an import of water from another large appointed water company. We consider our water trading incentives would unintentionally bias the market in favour of large appointed water companies if the import incentive did not also apply to imports from third parties to large appointed water companies. We propose that a large appointed water company is eligible for an import incentive for an import of water from a third party.</p>
<p>8. Export from a large appointed water company to a third party.</p> <p>Export incentive applies only in specific circumstances</p>	<p>If an export from a large appointed water company to a third party is not a regulated activity, then the appointed company can keep all the profits from such an export subject to compliance with our transfer pricing rules. Therefore, we propose that the export incentive does not apply in these circumstances. If an export from a large appointed water company to a third party is a regulated activity and the sale results in a genuine water trading activity – such as the sale of water to an intermediary that then trades the water on outside of the appointee's authorised area – then we propose that the water trading incentive would apply¹⁰.</p>

⁹ The water company will have to show that its import complies with an Ofwat-approved trading and procurement code for an import incentive to be paid at PR19.

¹⁰ The water company will have to show that its export complies with an Ofwat-approved trading and procurement code for an export incentive to be paid at PR19.

4.2 Consultation responses

We received five responses to our consultation, all from large appointed water companies. Three respondents supported our proposed clarification and one respondent made no comments. One respondent, Dŵr Cymru, supported our proposals but in the case of transaction 1 suggested that an export from a large appointed water company to a small appointed water company should be eligible for an export incentive in the case when the large appointed water company is not the local incumbent to the small appointed water company.

4.3 Our decision

In relation to transaction 1, we agree with Dŵr Cymru's point that if a large appointed water company exported water to a small appointed water company in another large company's appointed area, this could constitute a genuine water trade. None of the existing 42 new appointee sites are served in this way. The motivation for the export incentive was to overcome the artificial barriers to water trading between large appointed companies. The case Dŵr Cymru describes could be similar to a water trade between large appointed water companies, and – for consistency – it would be appropriate for the export incentive to apply in such a case. The large appointed water company will have to show that its export complies with an Ofwat-approved trading and procurement code for an export incentive to be paid at PR19.

In relation to transactions 2-8, four respondents supported our proposals and one made no comment. Therefore, we propose to retain the approach to applying the water trading incentives to those transactions as set out in our consultation letter of 18 January 2016.

The table below summarises our decision on how the water trading incentives apply to particular transactions.

Table 6: Decision on how the water trading incentives apply to particular transactions

Description of transaction	Decision on whether the incentive applies
1. An export from a large appointed water company to a small appointed water company.	<p>Export incentive applies only in specific circumstances</p> <p>Almost all new water appointee sites are served by a bulk supply export from the local large appointed water company. The motivation for the export incentive was to overcome the artificial barriers to water trading between large appointed companies. We do not have evidence of artificial barriers to trading that have prevented new appointee sites from receiving supplies. Subject to the exception below, we have decided that the export incentive does not apply to a large appointed water company exporting water to a small appointed water company.</p> <p>In the case where a large appointed water company exports water to an area served by a small appointed water company that is surrounded by another large company's appointed area, this could constitute a genuine water trade. If it is a genuine water trading activity, then the export incentive would apply¹¹.</p>
2. Import to a small appointed water company from a large appointed water company.	No import incentive applies
3. Import to a large appointed water company from a small appointed water company.	Import incentive applies ¹²
4. Export from a small appointed water company to a large appointed water company.	No export incentive applies
5. Import to a small appointed water company from a third party.	No import incentive applies
6. Export from a small appointed water company to a third party.	No export incentive applies
7. Import to a large appointed water company from a third party.	Import incentive applies ¹³

¹¹ The water company will have to show that its export complies with an Ofwat-approved trading and procurement code for an export incentive to be paid at PR19.

¹² The water company will have to show that its import complies with an Ofwat-approved trading and procurement code for an import incentive to be paid at PR19.

¹³ The water company will have to show that its import complies with an Ofwat-approved trading and procurement code for an import incentive to be paid at PR19.

Description of transaction	Decision on whether the incentive applies
<p>8. Export from a large appointed water company to a third party.</p>	<p>Export incentive applies only in specific circumstances</p> <p>If an export from a large appointed water company to a third party is not a regulated activity, then the appointed company can keep all the profits from such an export subject to compliance with our transfer pricing rules. Therefore, we have decided that the export incentive does not apply in these circumstances. If an export from a large appointed water company to a third party is a regulated activity and the sale results in a genuine water trading activity – such as the sale of water to an intermediary that then trades the water on outside of the appointee’s authorised area – then we have decided that the water trading incentive would apply¹⁴.</p>

¹⁴ The water company will have to show that its export complies with an Ofwat-approved trading and procurement code for an export incentive to be paid at PR19.

5. Reconciliation rulebook and spreadsheet revisions

Following further review of the reconciliation rulebook and accompanying spreadsheets, stakeholders identified a number of minor issues around the calculations. We have resolved these and we have published [revised versions](#) of the reconciliation rulebook and the accompanying spreadsheets on our website. Below, we set out details of the models affected and a summary of the issues corrected in each of them.

Four models have been adjusted. These are:

- WRFIM;
- totex menu;
- household retail; and
- CIS.

The first three have had calculations updated, whereas the only update in the CIS spreadsheet is to an input value.

Table 7: Summary of rulebook and spreadsheet revisions

Model	Issue identified	Change to resolve issue	Sheet	Row
WRFIM	Wrong year referenced in WRFIM water worksheet. Allowed Revenue from final determinations for 2015-16 incorrectly references 2014-15.	Formula in cell L28 amended to reference L15.	WRFIM – Water	L28
WFRIM	Formatting of Cells L27 and L28 on Data worksheet incorrect.	K27 and K28 formatted as input cells. L27 and L28 formatted as blank cells.	Data	L28,L27, K27, K28
WFRIM	Financing costs incorrectly applied to year 4 penalty.	Financing costs removed from formulae.	WFRIM – Water WFRIM – Waste	P64
Totex menu	Transition expenditure incorrectly treated.	Calcs L162 and L163 adjusted to include transition expenditure occurred in 2014-15. This means that the RCV adjustment correctly works regardless of whether expenditure occurred in 2014-15 or later years.	Calcs	162 and 163

Model	Issue identified	Change to resolve issue	Sheet	Row
Totex menu	Pension deficit repair cost reconciliation.	Calculations removed for this. Water non-menu revenue adjustment formulae amended to reflect this. Sewerage non-menu revenue adjustment removed, as it related only to PDRC.	Calcs	118, 119, 120, 127, 131, 187
Totex menu	Other cost exclusions.	Calculations for totex over and under performance calculation adjusted to ensure that there is no ex post adjustment that reflects differences between the actual cost and the cost included in the final determinations.	Calcs	Row 162 and 163
Household retail	Revenue sacrifice functionality added. This allows companies to declare voluntary revenue sacrifice – for example, where a company wants to offer discounts to customers.	Added Revenue sacrifice and Actual revenue net of sacrifice to the inputs worksheet.	Inputs	35-57
CIS	Incorrect run-off rate input values for Thames.	Values reflect the PR14 final determination data.	Inputs	40

Ofwat (The Water Services Regulation Authority) is a non-ministerial government department. We regulate the water sector in England and Wales. Our vision is to be a trusted and respected regulator, working at the leading edge, challenging ourselves and others to build trust and confidence in water.

Ofwat
Centre City Tower
7 Hill Street
Birmingham B5 4UA

Phone: 0121 644 7500
Fax: 0121 644 7533
Website: www.ofwat.gov.uk
Email: mailbox@ofwat.gsi.gov.uk

Printed on 75% minimum de-inked post-consumer waste paper.
February 2016

ISBN 978-1-910739-42-6

© Crown copyright 2016

This publication is licensed under the terms of the Open Government Licence v3.0 except where otherwise stated. To view this licence, visit nationalarchives.gov.uk/doc/open-government-licence/version/3 or write to the Information Policy Team, The National Archives, Kew, London TW9 4DU, or email psi@nationalarchives.gsi.gov.uk.

Where we have identified any third party copyright information, you will need to obtain permission from the copyright holders concerned.

This document is also available from our website at www.ofwat.gov.uk.

Any enquiries regarding this publication should be sent to us at mailbox@ofwat.gsi.gov.uk.

