July 2015

Trust in water

The PR14 reconciliation rulebook policy document

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Contents

Overview		2
Appendix 1:	Assessment framework	9
Appendix 2:	Outcomes	13
Appendix 3:	Wholesale water and wastewater costs and revenues	34
Appendix 4:	Reconciliation of PR09 incentives	71
Appendix 5:	Household retail	81
Appendix 6:	Other issues	88
Appendix 7:	Responding to the consultation on WRFIM issues	92

Overview

This document sets out our approach to the reconciliations that will be required at the end of the 2015-20 price control to take account of past performance and the various price control incentive mechanisms. We consider that setting out our approach now will provide greater clarity to customers, companies and wider stakeholders, and is consistent with building trust and confidence in the water sector. This document follows our March 2015 consultation on these matters and explains how we have responded to the points that consultees raised.

The mechanisms that the rulebook covers could have a material impact on company revenues, the RCV and the delivery of customer outcomes from the £44 billion of expenditure in the price control.

Part of the 2019 price review (PR19) will be the calculation of adjustments to take account of past performance and incentive mechanisms. This is particularly important given the potential materiality of the adjustments and that the way that adjustments are calculated can be complex and open to different possible interpretations.

In our final determinations at the 2014 price review (PR14), we acknowledged that PR14 represented a significant evolution of Ofwat's historical approach to price controls. As a result, it is not practicable to rely on the approach and guidelines we used in the past for reconciliations. So, we committed to produce a 'PR14 reconciliation rulebook'.

The objective of our reconciliation rulebook is to explain how we will take into account performance over 2015-20, along with those factors not reconciled from the 2009 price review (PR09), at PR19. We consider that this is important as it will help promote predictable and transparent regulation, and confidence across the sector.

By providing companies with clear reconciliation rules now we will:

- avoid the situation where companies fail to act in the interests of customers because they make incorrect assumptions about the way that PR14 reconciliations will be carried out; and
- provide clarity to investors, which will facilitate investment in the long-term interests of customers.

The PR14 reconciliation rulebook describes the way that we will reconcile companies' 2015-20 performance against the PR14 final determinations at PR19, through the following mechanisms.

- **Outcome delivery incentives (ODIs)**, which provide companies with rewards for achieving stretching performance targets and compensate customers if performance is below performance targets.

- **Wholesale total expenditure (totex) sharing**, where company over- and underperformance is shared with customers.

- **Wholesale revenue forecasting incentive mechanism (WRFIM)**, which provides financial incentives for companies to provide accurate forecasts, and ensures under- and over-recovery is reconciled.

- **PR09 reconciliation** (blind year adjustments).

- **Household retail**, where the total revenue allowance is adjusted for actual customer numbers.

For each mechanism, the rulebook sets out the treatment of inflation and whether companies and customers should be compensated for the time value of money and taxation.

We have developed our conclusions after our consultation on the draft PR14 reconciliation rulebook, which we published in March 2015[1]. We received 21 responses to the consultation, which included:

- all 18 monopoly water companies;
- the Consumer Council for Water (CCWater);
- the Environment Agency; and
- a member of the public.

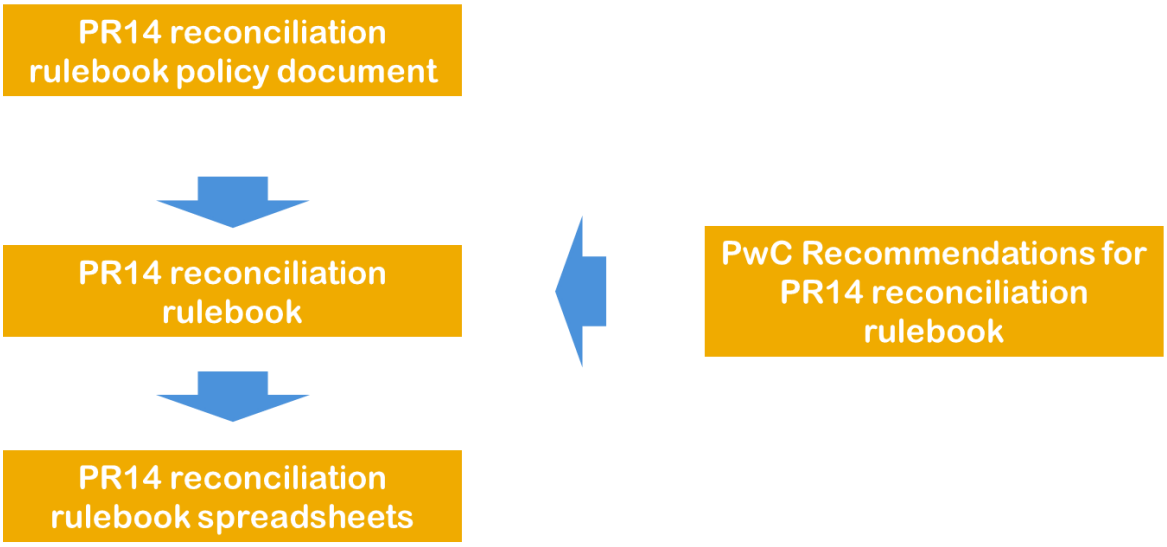
[1] 'Consultation on the PR14 reconciliation rulebook', March 2015.

In general, respondents welcomed the PR14 reconciliation rulebook – in particular, the greater clarity it provided at the start of the 2015-20 control period. Most respondents agreed with the majority of the proposals although respondents proposed different approaches in some areas. We appreciate the responses that we received from stakeholders – we have considered these when developing the final rulebook.

The PR14 reconciliation rulebook does not include our conclusions on the reconciliation of PR09 capital expenditure (capex) incentive (CIS) scheme. We consulted on a forward-looking adjustment to adjust for inflation, following the issues that we highlighted in our final determinations. The Competition and Markets Authority (CMA) is currently considering Bristol Water's price determination appeal. While the CMA has provisionally decided not to address this issue as part of the appeal, we consider it would be appropriate to conclude on the CIS issue later in the year when the CMA's process has ended.

The PR14 reconciliation rulebook is part of a suite of complementary documents and illustrative spreadsheets, as set out in figure 1 below.

Figure 1 Structure of PR14 reconciliation documents



Summary of proposed approach to key policy issues in the PR14 reconciliation

Table 2 below summarises our approach to the key policy issues in the PR14 reconciliation. Where there are policy choices, we have considered these using assessment criteria based on our statutory duties, as set out in appendix 1. We

provide further details of our assessment of each of the policy areas in the appendices.

Following the consultation, we have amended our approach in two areas.

- PR09 reconciliation, where we have altered the materiality threshold on blind year adjustments so that changes are not made if they are immaterial (less than £10,000) because of concerns with consistency with the adjustments made at PR14.

- Household retail revenue, where we will only include a time value of money adjustment if the difference between recovered and allowed revenue is greater than 2%, consistent with the approach to introduction of penalties for wholesale revenues.

We have also made a number of more minor adjustments – for example, to the definition of totex – and to the calculation spreadsheets themselves, which are set out in the rulebook.

We have not made a final decision on the reconciliation of the wholesale revenue forecasting incentive mechanism (WRFIM) as we have identified an issue on the consistency between the WRFIM formula and the licence. So, we are inviting views on:

- the potential drafting for a licence modification to allow the licence to be consistent with the original WRFIM formula;
- whether companies would support such a licence modification; and
- whether we should:
  - use the revised WRFIM formula for all companies;
  - 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); and
  - only introduce a sector-wide licence modification if all companies agree to the proposed change.

We would be grateful for views on these issues by **10 August 2015**.

Appendix 7 includes details on how to respond to this issue. We are not inviting views on the other aspects of the PR14 reconciliation, where this document sets out our decision on these issues.

Table 2 Summary of the proposed approach on key areas and further information

Issue	Proposed approach	Further information
Outcome delivery incentives		Appendix 2
Indexation	Use Nov-Nov lagged RPI to index in period ODIs	
Time value of money	Do not adjust for time value of money	
Taxation	Allow a tax adjustment on ODI rewards and penalties as part of PR19 review	
Aggregate cap and collar	Do not adjust ODI rewards and penalties for taxation for comparison with cap	
Scheme ODIs	We set out principles that will apply to the assessment of major scheme ODIs in PR19	
Asset health ODIs	Require companies to publish further details for asset health measures where these are not included in PR14 final determinations	
Wholesale – totex		Appendix 3
Definition of totex for menu sharing	Exclude items not included in the menu baseline such as third party costs, pension deficit recovery and transition costs	
Indexation	Deflate future year total expenditure using actual average RPI for comparison for PR14 allowance	
Allocation of totex out- and underperformance to revenue and RCV	Allocate out- and underperformance using weighted average PR14 PAYG rate, with companies providing robust evidence for changes that are in customers' interests	
Time value of money	Adjust for time of money for customer sharing of out-/underperformance	

Issue	Proposed approach	Further information
Taxation	Do not adjust for tax on revenue changes, but allow taxation allowances to be adjusted for RCV changes going forward	
Wholesale – WRFIM		Appendix 3
WRFIM formula	Further consultation on whether we amend the licence or the WRFIM formula to ensure consistency	
In-period ODIs	Include revenue from in-period ODIs in allowed revenue for WRFIM calculations	
Taxation	Do not include taxation adjustment in PR19	
Blind year	Include blind year adjustment in PR19	
Water trading incentives		Appendix 3
Export incentive	Payment at PR19 of 50% of the full discounted economic profit for the forecast life of the export capped at 100% of the economic profit for the years the export operates in 2015-20	
PR09 reconciliation		Appendix 4
COPI	Adjust for COPI when accurate data becomes available (for example, in 2016)	
Blind year	Include a materiality threshold for the blind year adjustment	
Household retail		Appendix 5
Reconciliation	Include a wash-up between allowed and outturn revenues in PR19	

Issue	Proposed approach	Further information
Time value of money	Adjust for time value of money for material differences between recovered and allowed revenue	
Taxation	Do not include taxation adjustment in PR19	

Appendix 1: Assessment framework

In our final determinations, we defined the incentive mechanisms that would apply over 2015-20. We recognise that in some cases there can be more than one interpretation for how a mechanism should operate, or there can be different options for how it should be implemented. To guide how we should make the reconciliation at PR19, and therefore the contents of the reconciliation rulebook, we developed and applied an assessment framework.

A1.1 Consultation responses

We received two responses on the assessment criteria.

- The Environment Agency stated that assessment criteria should specifically mention the environment.
- Severn Trent Water stated that the assessment needs to consider the impact on company financeability as the reconciliations could have a significant impact on the shadow RCV during the period.

A1.2 Our decision

Our secondary duties include to contribute to the achievement of sustainable development and we consider that the assessment criteria set out in the March 2015 already implicitly include consideration of the environment. But to make this clear, we have made this explicit in the explanation of how we have applied our criteria, which we summarise below.

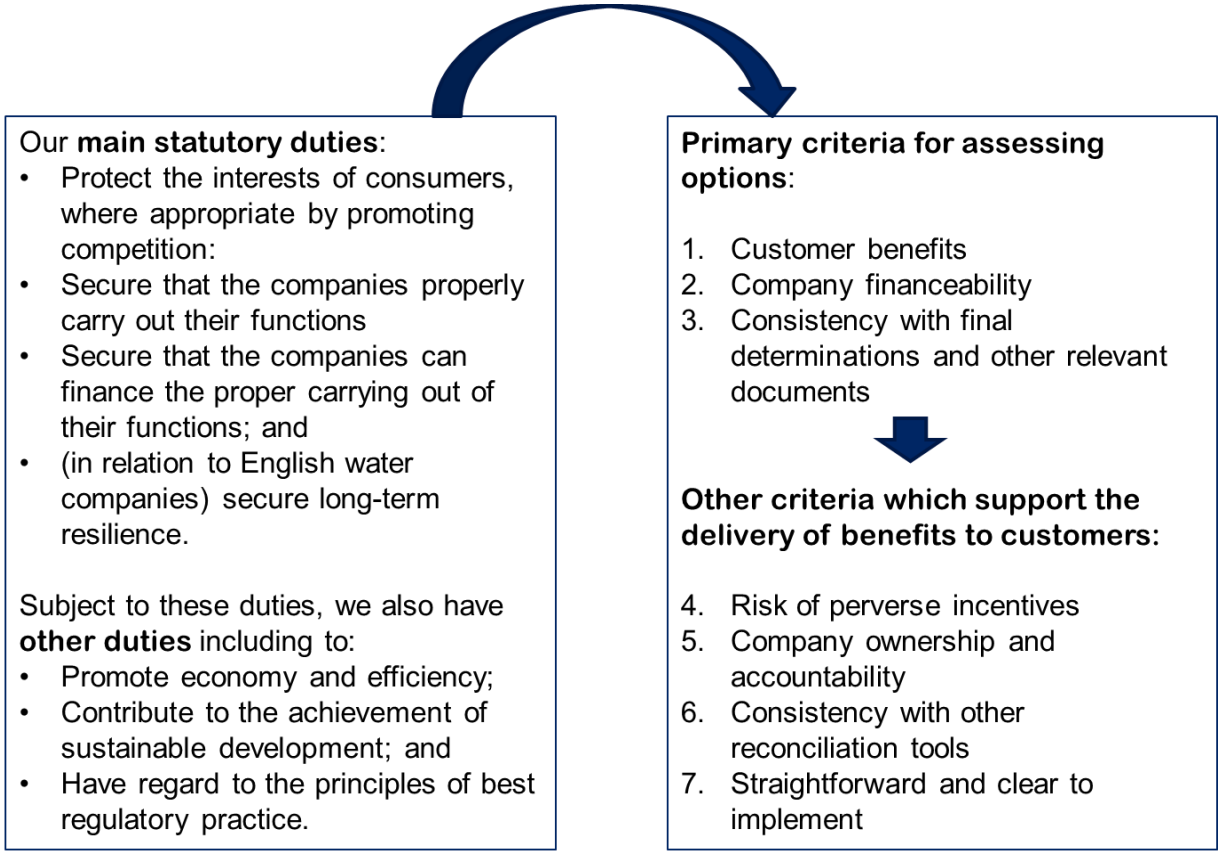
The assessment criteria explicitly reference the impact on company financeability, although it is not always practicable to identify this precisely now as the impact of PR14 reconciliation decisions will be, for most cases, dependent on the performance of the company during the control period.

As noted in the overview, we will reach conclusions on the indexation of the PR09 CIS arrangements later this year. In doing so, we will have regard to our statutory duties, including in relation to securing that companies can finance the proper carrying out of their functions.

We also note that in PR14 we assessed company financeability before the impact of the PR09 reconciliation. If we follow the same approach when we carry out the PR14 reconciliation in PR19, then the decisions on the approach to the PR14 reconciliation would not impact on our assessment of company financeability.

Based on this, we therefore confirm our assessment criteria as derived from our statutory duties figure A1.1 below.

Figure A1.1 Assessment criteria



Our assessment assigns a Red, Amber, Green (RAG) score for each criterion. Where a Red score is assigned to any of the first three criteria, we do not proceed with the assessment because this would be inconsistent with Ofwat's statutory duties. Often, our assessment is more finely balanced, requiring trade-offs between criteria; because there is more than one credible option.

The way we have interpreted the criteria for the RAG assessment is set out below.

Criteria	How this has been applied
1. Customer benefits	Assessment of likely customer benefits, both in 2015-20 and post-2020. If option is likely to result in any customer detriment (RED score), do not proceed.
2. Company financeability	Qualitative consideration of likely impacts on company financeability. If option has a clear impact on financeability (RED score), do not proceed.
3. Consistency with final determination and other relevant documents	Comparison with policy set out in final determinations and other relevant policy documents. If an option is inconsistent with the final determinations or our policy this will undermine stability and predictability (RED score). If there is an option available that is consistent, do not proceed with an inconsistent option unless the inconsistency relates to a mistake in the published documents.
4. Risk of perverse incentives	Qualitative assessment of whether the options are likely to appropriately incentivise company behaviour. Options which incentivise companies to deliver for their customers and take appropriate account of wider benefits (including the environment) are preferred.
5. Company ownership and accountability	Consistent with the principles of PR14, companies should retain accountability for delivering their plans and demonstrating how their performance results in an adjustment which is consistent with the final determinations. Likewise, there should be no undue regulatory burden. Options which promote these principles are preferred.
6. Consistency with other reconciliation tools	Comparison against PR14 financial model and relevant PR09 models, and agreed approach. Options with greater consistency are preferred (though noting that the PR14 mechanisms reflect the step-change adopted in the PR14 methodology so consistency with PR09 is not always intended).
7. Straightforward and clear to implement	Qualitative assessment of the complexity of an option, and ease of implementation by companies and Ofwat. Options which are straightforward and clear are preferred.

A1.3 Scope of assessment

In the rest of this document, we set out the assessment of key policy decisions against the criteria. All of the other technical assumptions required to implement the reconciliations are documented and set out in the PR14 reconciliation rulebook and supporting spreadsheets.

Appendix 2: Outcomes

A2.1 Introduction

The PR14 final determinations included 522 performance commitments and 316 financial outcome delivery incentives (ODIs). These financial ODIs are taken by the companies as either:

- adjustments to revenue, which are recovered over the short term; or
- adjustments to the RCV, which are recovered over the longer term.

The ODIs for each company are set out in annex 4 of the company-specific appendix for each company's final determination.

For most companies, and most financial ODIs, the rewards and penalties will need to be reconciled towards the end of the 2015-20 period so that they can be taken into account in the PR19 final determinations. Three companies (Anglian Water, Severn Trent Water and South West Water) included licence modifications to allow some financial ODIs to be taken during the 2015-20 period ('in period'). The final determinations set out the process for making adjustments, but do not set out in detail how the adjustments will be made.

We have considered the following key issues in the reconciliation of outcomes, consistent with the approach taken in our consultation. The detailed approach to the reconciliation is set out in the PR14 reconciliation rulebook and supporting spreadsheets.

- **Treatment of inflation.** The rewards and penalties for financial ODIs are set out in 2012-13 prices and the reconciliation needs to consider whether an adjustment is required to reflect future prices.

- **Treatment of time value of money.** For some ODIs the rewards and penalties will be achieved in specific years but will only be paid later or at the end of the period. The reconciliation needs to consider whether an adjustment is required to reflect the difference in the value of receiving/paying money when the financial reward or penalty was achieved and when the reward or penalty was received/paid by the company.

- **Treatment of taxation.** Whether the financial rewards and penalties should be adjusted to take account of taxation so that the companies receive the net reward or penalty set out in the final determinations.

- **The detailed operation of the aggregate ODI cap and collar** following the principles set out in the final determinations.

- **The treatment of scheme ODIs** where the level of detail varies between companies. So we have considered whether we should provide further details (or request companies to do so) to clarify how these schemes will be assessed.

- **The treatment of asset health ODIs** where for some companies with composite indices or basket measures it is not clear how the indices or basket measures will be calculated.

- **The treatment of other ODIs.**

A2.2 Treatment of inflation

Consistent with the general approach specified in the final determinations, the ODI financial rewards and penalties are assumed to be in average 2012-13 prices. These financial rewards and penalties will need to be translated to future year prices for payment to/by the company.

Consultation document

For those ODIs that will be paid at the end of the 2015-20 period, we considered that we should index the rewards and penalties in line with changes in the actual retail price index (RPI), as this reflects how prices have changed in the rest of the economy – that is, if we were changing from 2012-13 prices to 2017-18 prices we would use the change in the Retail Price Index (RPI) between 2012-13 and 2017-18 (based on financial year averages).

Three companies (Anglian Water, Severn Trent Water and South West Water) were granted licence changes to allow some ODIs to be paid during the 2015-20 period. It will not be possible to use the RPI to uplift rewards and penalties as the RPI for the year in which the ODI will be paid will only be known at the end of the year. So we proposed that we should use lagged November to November RPI as it was consistent with the indexation used in setting k and the wholesale revenue forecasting incentive mechanism (WRFIM).

Consultation responses

All fifteen respondents who commented supported the approach to use actual year average RPI to index PR14 values to PR19 and to use lagged November to November RPI to index in-period ODIs. Two respondents made additional points.

- Bristol Water, stated that, while it did not have any in-period ODIs there should be a true-up at the end of the period for the difference between November and average RPI as it was not set out in the final determinations that different approaches would apply.

- CCWater highlighted concerns over financial rewards and suggested that the allowance for RPI should be included within the financial boundary for ODIs.

Our decision

Bristol Water suggested that there should be a true-up for differences between year average and November to November RPI for ODIs. We consider that difference between November to November and year average RPI is likely to be small and will only be applied to a small number of ODIs, which companies have elected to take in period. The extra complexity of additional true-up does not appear to be appropriate or justified.

We recognise that CCWater has raised concerns over the existence and level of financial rewards throughout the PR14 process. We consider that financial rewards and penalties are important to incentivise companies to deliver outcomes that customers want. The level of financial rewards and penalties is based on customer willingness to pay (WTP) evidence and so reflects the values that customers themselves place on achieving these outcomes. If we did not adjust financial rewards for inflation it would, in effect, reduce the value of the rewards, removing the link to customer WTP and alter the balance with financial penalties. Therefore, we do not consider it would be appropriate not to index financial rewards.

So, for the reasons set out above, and taking into account the consultation responses, **we continue to consider that Option 1, using lagged November to November RPI is the appropriate approach**.

Table A2.1 Assessment of options for the indexation of in-period ODIs

Criteria	Option 1: Nov-Nov RPI	Option 2: Forecast RPI, no adjustment	Option 3: Forecast RPI with adjustment
Customer benefits			
Company financeability			
Consistency with final determination and other relevant documents			
Risk of perverse incentives			
Company ownership and accountability			
Consistency with other reconciliation tools			
Straightforward and clear to implement			
Preferred option	✓	×	×

A2.3 Treatment of time value of money

The time value of money is the idea that money available now is worth more than the same amount in the future, as, during this time, the money can earn interest (or be used to pay down debt or equity).

A number of the ODIs are based on annual performance, but only take effect in the next price control – for example, annual performance against a leakage target. This creates a timing difference between when the company achieves the reward and penalty and when this is paid. This same timing difference also affects in-period ODIs in that whether a reward or penalty has been achieved for a particular year will only be known after the end of that year (in the year after) and can only be taken into account in setting charges for the year after that.

Consultation document

In the consultation, we proposed that we should not adjust for the time value of money for ODIs because for most ODIs it was always envisaged that the changes in revenues would only take effect in the next price control, and companies had the option of a licence amendment if they wanted ODI rewards and penalties to crystallise sooner.

Consultation responses

Nine respondents supported the proposal not to adjust for the time value of money as this approach was simple, practical and consistent with their understanding of ODI rewards and penalties.

Five respondents (Northumbrian Water, Severn Trent Water, Bournemouth Water, South East Water and Sutton & East Surrey Water) did not agree with the proposal. The main points raised were that:

- it created a lack of consistency – for example, between in-period and end of period ODIs;
- it risked perverse incentives – for example, as it may cause companies to delay expenditure on items which deliver benefits to customers; and
- adjusting for the time value for money was not overly complex as companies could be asked which ODIs accrued in period and which at the end.

Our decision

We continue to consider that identifying which ODIs accrue in period and which accrue at the end of the period would be relatively complex. Taking into account the consultation responses, most companies did not envisage in their business plans that ODIs would accrue in period. The complexity of identifying which ODIs accrue in period is highlighted by:

- some ODIs are calculated annually but affect the RCV (via the midnight adjustment) which can only be adjusted at the end of the period;

- some are "calculated based on actuals for year 1 to 4 and forecast for year 5"[2]; and
- while for others "performance is measured annually and rewards and penalties apply at the end of the period"[3].

For some companies, this is further complicated as all rewards are meant to be taken as one type of adjustment (for example, a revenue adjustment) and all penalties as another type (for example, an RCV adjustment) including those based on annual performance[4]. As a result, it is unclear which ODIs accrue in period and which accrue at the end of the period. Also, while it could be argued that to achieve some ODIs companies may have to incur additional expenditure (and so should be accrued in period), this will not always be the case and management action/focus can often be a more important determinant than expenditure in the achievement of outcomes.

In addition, we have not seen substantive evidence that suggests our proposed approach would cause perverse incentives or create substantial inconsistencies between groups of companies. We note that all companies had the option of a licence modification that would have allowed in-period adjustments for rewards and penalties.

So, taking the consultation responses we received into account, **we continue consider that we should NOT adjust for the time value for ODIs (Option 1).**

[2] For example, Thames Water's performance commitment WB5: average hours lost supply (page 204 of Thames Water's company-specific appendix).
[3] For example, Portsmouth Water's performance commitment A2: water quality standards (page 82 of Portsmouth Water's company-specific appendix).
[4] This is the case for Yorkshire Water; for United Utilities the opposite is true.

Table A2.2 Assessment of options for adjusting for time value of money for ODIs

Criteria	Option 1: No time value of money adjustment	Option 2: Time value of money adjustment
Customer benefits		
Company financeability		
Consistency with final determination and other relevant documents		
Risk of perverse incentives		
Company ownership and accountability		
Consistency with other reconciliation tools		
Straightforward and clear to implement		
Preferred option	✓	×

A2.4 Treatment of taxation

Financial rewards and penalties related to ODIs can be made net or gross of taxation – that is, companies can receive an adjustment to take account of taxation so that the companies receive the net reward or penalty set out in the final determinations, or no adjustment for taxation can apply. If ODIs impact on the tax allowance in the next control period, then rewards would tend to increase the tax allowance (as rewards would increase total revenues, forecast profits, tax allowances and prices) whereas penalties would reduce the tax allowance (as they would reduce total revenues, forecast profits, tax allowances and prices).

Consultation document

While we recognised that the arguments were finely balanced, we proposed that there would be an adjustment to the tax allowance for ODIs as this would be consistent with a post-tax regulatory framework (where the price control revenue allowances are calculated on a post-tax basis) and avoid the potential inconsistencies of other approaches (where under some options tax adjustments would only be provided for some ODIs and not others). We recognised that this approach created a potential inconsistency with customer WTP research on which many of the ODIs were based.

Consultation responses

We received 13 responses to the tax treatment of ODIs. Eight respondents agreed with this proposal and five disagreed. The main issues for respondents that disagreed with our proposed approach were as follows.

- CCWater stated that customers would be paying around 20% more than their WTP for rewards that may lead to a negative perception from customers. Some companies raised similar concerns.

- Southern Water and United Utilities raised concerns that it was not consistent with their understanding of the final determinations.

- Southern Water raised concerns that this will increase their already potentially significant penalties and it was not adequate justification for us to state that this approach is in customers' interests simply because the final determinations include more penalties than rewards.

Our decision

In light of respondents' views, we reconsidered whether it is appropriate to provide a tax adjustment on ODIs based on the four options included in the consultation.

Option	PR19 RCV adjustments	PR19 revenue adjustments	In-period revenue adjustments
Option 1	Tax adjustment	Tax adjustment	Do not adjust for tax
Option 2	Tax adjustment	Tax adjustment	Tax adjustment (based on marginal tax rate)
Option 3	Tax adjustment	Do not adjust for tax	Do not adjust for tax
Option 4	Adjust ODIs rewards and penalties in PR19 to offset tax adjustment.	Do not adjust for tax	Do not adjust for tax

We continue to consider that **Option 2, allowing a tax adjustment is the most appropriate approach** because:

- it would not require an adjustment to the incentive payments and revenues input into the financial modelling; it would only involve taking account of the associated revenues in the calculation of corporation tax, which would mean that the corporation tax allowances better reflected the actually tax that companies would pay;
- it would avoid potential inconsistencies (and perverse incentives) of some of the alternative approaches (that is, Options 1 and 3) in that all ODIs would receive a tax allowance regardless of whether they are revenue or RCV adjustments;
- it avoids a complex adjustment to the rewards and penalties that would be added to the RCV under Option 4 (do not adjust for tax on any adjustments). RCV adjustments have an impact on tax through the tax allowance provided on the return and RCV run-off. To avoid a tax allowance on RCV adjustments we might need to create two separate RCVs, one where tax is applied (for the normal RCV) and one where tax is not paid (for the ODI adjustments). These separate RCVs would need to be maintained until the ODIs have been fully run-off, which may be a number of price controls in the future. An alternative would be to factor down the rewards and penalties that go into the RCV so that the net impact is the same as if a tax adjustment was not paid. This would require an estimate of the marginal taxation rate paid by the companies not just in the next price control but all subsequent price controls. This is further complicated by the impact of capital allowances, allowing some companies to pay no tax in some periods;
- it would ensure consistency between in-period and end period ODIs as in-period ODIs can be adjusted to reflect tax impacts based on the marginal rate of tax[5]; and
- we do not consider that this is inconsistent with the final determinations as we did not set out in the final determinations how we would treat taxation on ODIs.

[5] All three companies that receive in-period ODIs (Anglian Water, Severn Trent Water and South West Water) currently pay tax and so any change in revenues is expected to be at the marginal rate of tax.

Table A2.3 Assessment of options for the treatment of taxation for ODIs

Criteria	Option 1: Tax allowance (except in-period ODIs)	Option 2: Tax allowance for all ODIs	Option 3: No tax allowance (except RCV adjustments)	Option 4: No tax allowance (recalibration to offset RCV adjustments)
Customer benefits				
Company financeability				
Consistency with final determination and other relevant documents				
Risk of perverse incentives				
Company ownership and accountability				
Consistency with other reconciliation tools				
Straightforward and clear to implement				
Preferred option	×	✓	×	×

A2.5 Aggregate ODI cap and collar

In our final determinations (in policy chapter A2 on outcomes), we set out our proposals for an aggregate cap and collar on the financial impact of outcome delivery rewards and penalties. We recognised that the outcomes framework is an innovative new approach and therefore subject to a degree of uncertainty. The aggregate cap and collar is intended to provide a safeguard to both customers and companies by placing limits on the financial impacts of outcome incentives.

Applying the cap and collar will limit the aggregate rewards and penalties from outcome incentives earned during the 2015-20 price control to a maximum of +/-2% of notional regulated equity. This limit will be applied to the aggregate rewards and penalties within the wholesale water and wastewater controls separately.

Consultation document

We proposed that we should not adjust the aggregate cap and collar of 2% of equity, as this was consistent with providing a tax allowance on ODI rewards and penalties.

Consultation responses

Nine respondents agreed with this proposal.

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

- Bournemouth Water was unclear over the proposal but agreed there should be consistency with the tax treatment;
- Sutton & East Surrey Water and Portsmouth Water considered that the proposal was a departure from the final determinations, although Portsmouth Water considered that this was in customers interests;
- consistent with their view on the tax treatment of ODIs, Southern Water, Bristol Water and United Utilities did not agree with the proposed approach; and
- United Utilities said that the calculation of separate ODI rewards and penalties for revenue and RCV adjustments did not reflect how their proposed ODIs were intended to operate, where the adjustment is to revenue or RCV depending on whether the net position is a penalty or reward.

Our decision

We have considered two options to adjust the aggregate cap and collar.

In Option 1, we have not applied an adjustment to the cap and collar. This was the preferred option in the consultation and is consistent with including ODI incentives in the PR19 revenue allowances and RCVs that tax is applied to – in that the tax allowance will fully compensate companies for tax and so a straightforward comparison can be made with the notional return on equity derived from the price control modelling.

In Option 2, we have reflected the position from the final determinations where we assumed that no tax allowance would be provided on ODI incentive payments and so it would be necessary to adjust the cap to take account of the impact of tax. This was done by adjusting the rewards and penalties from outcome incentives by a factor of 80% to reflect a notional marginal tax rate of 20%. The aggregate post-tax rewards and penalties were then limited to 2% of notional regulated equity. We illustrate these options and our assessment in table A2.4 below.

We consider that **Option 1, where we do not apply the 80% factor to rewards and penalties is the most appropriate approach**. This is because it is consistent with the approach described above for the treatment of taxation for ODIs (where we allow a tax adjustment). We recognise that this is not consistent with the description of the aggregate cap set out in the final determinations – but as we have clarified the treatment of ODI payments in the calculation of tax it is necessary to specify the cap consistently with this clarification.

We have also considered the ODI approach used by United Utilities (and Yorkshire Water) where ODI rewards and penalties impact on either the RCV or revenue depending on whether there are net rewards or penalties. All other companies' rewards and penalties will result in a net change to revenues and the RCV based on the overall balance of rewards or penalties. So, we do not consider that the position of United Utilities (or Yorkshire Water) is markedly different to other companies. Therefore, we think that we should continue to calculate whether rewards or penalties should be capped using separate calculating based on the total rewards and the total penalties rather than calculating the net position across rewards and penalties. This should apply to United Utilities and Yorkshire Water as it does to other companies. This is consistent with the approach set out in the final determinations.

Table A2.4 Assessment of options for the application of ODI caps and collars

Criteria	Option 1: Do not adjust rewards and penalties for tax	Option 2: Adjust ODI rewards and penalties for tax
Customer benefits		
Company financeability		
Consistency with final determination and other relevant documents		
Risk of perverse incentives		
Company ownership and accountability		
Consistency with other reconciliation tools		
Straightforward and clear to implement		
Preferred option	✓	×

A2.6 Scheme ODIs

The final determinations included a number of scheme ODIs. Their purpose is to ensure that:

- companies are incentivised to deliver the outcomes for customers associated with delivering major schemes; and
- customers are protected if a company were to fail to deliver on its commitments.

There are four main categories of ODIs related to major schemes. These are:

- delivery of a scheme;
- statutory requirements;
- milestones; or
- measureable outcomes.

Consultation document

In the consultation, we considered a range of options on whether, and to what extent, we should provide further details (or request companies to do so) to clarify how the delivery of these schemes will be assessed. The options ranged from 'do nothing' (Option 1) through to a full review of schemes by Ofwat (Option 5). The options are incremental.

We considered that Option 2, with Ofwat setting principles that will apply to the assessment of major scheme ODIs was the most appropriate response. We preferred this option on the basis that it:

- provides greater clarity on how we will assess scheme ODIs in PR19;
- is consistent with the final determinations;
- reduces the risk of perverse incentives;
- maintains company ownership for the delivery of schemes; and
- should be straightforward and clear to implement.

Consultation responses

We received 13 responses on scheme ODIs. Twelve respondents supported our proposed approach and two disagreed. The main issues raised by respondents disagreeing with our proposed approach were:

- concerns about giving the final determinations precedence over pre-acceptance clarifications and business plan information;
- a lack of clarity about the additional information that is expected from companies; and
- wanting some form of feedback or approval from Ofwat in period.

Our decision

We confirm that we will be following Option 2 for PR14 reconciliation – that is, **we are setting principles that will apply to the assessment of major scheme ODIs**.

We have made a change to the first bullet point of the principles following responses to the consultation. We have made it clear that, in addition to the final determinations, any clarifications we gave to companies ahead of their accepting their final determinations will take precedence over other documentation. We consider that the final determinations should not be inconsistent with the underlying business plan information, except in cases where there have been interventions.

We do not think it is appropriate to provide in-period feedback or approval of how companies are progressing their major schemes. We would not have the advantage of being able to make comparisons across companies or judge performance in the round. As other respondents noted, Option 2 balances a focused approach to regulatory intervention with maintaining company responsibility for delivery and innovation.

Our principles for assessing major schemes are as follows.

- In case of inconsistencies, the final determination**s and any pre-acceptance clarifications of those determinations will take** precedence over any **other** ~~**additional**~~ documentation. [Changes since the consultation in bold]

- At PR19, companies will be subject to a high burden of proof to demonstrate delivery of the project. For example, companies should provide information to show that:
  - a scheme is operational;
  - it has started to deliver the originally intended benefits to its customers;
  - an independent external party has confirmed the scheme has been delivered and is delivering the originally intended benefits[6]; and/or
  - significant milestones or benefits have been delivered, consistent with the definition in the ODI.

- There may be cases where companies have delivered the outcomes related to a scheme by finding an alternative, more innovative solution. If companies can demonstrate this, then it may be appropriate for the non-delivery incentive to be dis-applied or adjusted. However, companies should be subject to a higher burden of proof to demonstrate this. The non-delivery incentive will apply unless a company clearly demonstrates that it has delivered greater benefits to customers via an alternative scheme (to be reviewed on a case-by-case basis) or that the statutory requirement driving the scheme has been removed[7]. When making this assessment Ofwat will take into account

[6] The first three criteria are not intended to be either/or but reflect an increasing level of assurance that the scheme has been delivered which Ofwat will place greater reliance on when considering whether the scheme ODI has been met.
[7] Page 67, 'Final price control determination notice: policy chapter A2 – outcomes'.

evidence on customer preferences and benefits and the level of independent assurance provided.

- For the incentives regarding delay, we will carry out an assessment at the end of the financial year of projected completion and, if necessary, at the end of every subsequent financial year until completion is achieved. Where a scheme is not due for completion until after the next price control, we will carry out an assessment to demonstrate that delivery is on track at PR19. If this cannot be demonstrated, penalties for expected delay may be incurred at this milestone[8].

Table A2.5 Assessment of options for scheme ODIs

Criteria	Option 1	Option 2	Option 3	Option 4	Option 5
Customer benefits					
Company financeability					
Consistency with final determination and other relevant documents					
Risk of perverse incentives					
Company ownership and accountability					
Consistency with other reconciliation tools					
Straightforward and clear to implement					
Preferred option	×	✓	×	×	×

[8] Page 67, 'Final price control determination notice: policy chapter A2 – outcomes'.

A2.7 Asset health ODIs

Twelve companies have asset health ODIs based on composite indices or 'basket' measures. For a number of companies[9], it is not clear in the final determinations how the basket measures will be aggregated or composite indices will be calculated, and how performance against the ODI will be assessed – for example, in terms of the definitions of 'improving', 'stable', 'marginal' and 'deteriorating', and whether changes are 'persistent'. In some cases, companies have provided Ofwat with separate documentation clarifying the operation of these mechanisms. However, these documents are not generally publicly available.

Consultation document

We considered two options – a 'do nothing' option and our preferred approach of requiring companies to publish further information on the operation of their asset health indices and supporting formulae. We considered that **Option 2** would reduce the risk of perverse incentives – for example, redefining the calculation of the asset health ODIs in period, with potentially negative impacts on customers.

Consultation responses

We received 12 responses on asset health ODIs, which all supported our proposed Option 2 (requiring companies to publish additional information). Several companies commented that they were already planning to publish further information on their asset health ODIs.

Our decision

As there was unanimous support and for the reasons set out above, **we continue to consider that companies should publish additional information on asset health ODIs**.

[9] Our initial view is that this encompasses Anglian Water, Southern Water, South West Water, Thames Water, United Utilities, Dŵr Cymru, Yorkshire Water, Bristol Water, Bournemouth Water, South East Water and South Staffordshire Water.

Our next step will be to contact the companies we consider have not published sufficient information on how their asset health ODIs work to discuss what needs to be published. We will also discuss with the companies affected whether we need to review the information before they publish it.

Table A2.6 Assessment of options for asset health ODIs

Criteria	Option 1: Do nothing	Option 2: Companies publish additional information
Customer benefits		
Company financeability		
Consistency with final determination and other relevant documents		
Risk of perverse incentives		
Company ownership and accountability		
Consistency with other reconciliation tools		
Straightforward and clear to implement		
Preferred option	×	✓

A2.8 Other ODIs

A2.8.1 SIM

The service incentive mechanism (SIM) incentivises companies to improve service quality by providing financial rewards and penalties based on comparative performance.

Consultation document

In our consultation, we set out the main elements of the SIM for the next period based on our earlier separate consultation and conclusions.

Consultation responses

Portsmouth Water and Bournemouth Water acknowledged the approach to the SIM set out in our consultation.

Thames Water and Severn Trent Water made a number of detailed comments on the SIM, which we outline below.

- **Mapping of performance to rewards and penalties.** Thames Water asked for greater clarity on how SIM performance is mapped to rewards and penalties. It considered that this would lead to more effective incentives, as it would allow companies to more readily trade-off service improvements with the additional costs to customers, and therefore make efficient decisions in assessing which improvements will be cost-beneficial for customers.

- **Regional affluence/deprivation.** Thames Water stated that SIM rewards and penalties do not take proper account of regional affluence/deprivation.

- **Value of rewards and penalties.** Severn Trent Water stated that, while we have said that we will retain the current magnitude of the SIM, we have not set out how this will be achieved. The company also noted that as the household retail controls are not linked to RPI and the household retail control does not include a tax allowance, then the values would be lower than if directly linked to total revenues.

No other respondents commented on the SIM.

Our decision

We have already consulted on and set out our approach to the SIM. Our response to the points raised by Thames Water and Severn Trent Water are as follows.

- **Mapping of performance to rewards and penalties.** We consider that we should set not out the mapping of rewards and penalties to levels of SIM performance as this will provide some flexibility on how financial incentives are applied. This will help to avoid the position where small differences in performance could lead to large differences in financial rewards or penalties.

- **Regional affluence/deprivation.** We consulted on whether to maintain the current scale of the SIM financial incentive as part of the development of our final determinations and considered that the current level of the incentive, linked to company revenue, was appropriate to incentivise companies to improve service quality.

- **Value of rewards and penalties.** We consulted on linking the SIM financial rewards and penalties to household retail revenue as part of the development of our final determination. We considered that linking rewards and penalties to household retail revenue was appropriate as it would encourage all of the business elements that needed to work together to do so. We do not consider that we should revisit this conclusion.

Further details on the operation of the SIM are set out in 'Service incentive mechanism (SIM) for 2015 onwards – conclusions'.

A2.8.2 Other ODIs – measurement and assessment

For the large part, there is good information in the final determinations on how other ODIs (that is, ODIs that are not scheme-related, asset health or SIM) will be measured and rewards and penalties will be assessed. However, we accept that customer challenge groups (CCGs) and other stakeholders may want additional information on how some ODIs are assessed, to ensure that they can hold companies properly to account. Companies might also want to know information on how other companies are measuring their performance so that they can accurately compare their performance.

Consultation document

We proposed that companies' publishing additional information on how ODIs will be measured represents best practice as it provides greater transparency to all stakeholders. We considered that this approach could be followed for other areas where the final determinations do not provide sufficient detail. However, we emphasised that in the circumstances of a conflict between the final determinations and additional subsequent material published by companies, the final determinations take precedence.

Consultation responses

No-one responded directly on our proposed approach to companies providing additional information on how ODIs will be measured. However, in relation to scheme ODIs two companies raised concerns about giving the final determinations precedence over pre-acceptance clarifications and business plan information.

In addition, Northumbrian Water asked for greater consistency in the definitions of the performance commitments. Sutton & East Surrey Water commented that the link between willingness to pay and rewards/penalties was weak in some cases. CCWater raised a concern about customers being reluctant to accept companies earning rewards for outperformance.

Our decision

As there were no direct comments on our proposal that companies' publishing additional information on how ODIs will be measured represents best practice as it provides greater transparency to all stakeholders, we are maintaining our preferred approach. We consider that this approach should be followed for other areas where the final determinations might not provide sufficient detail.

In keeping with our approach to scheme ODIs in the circumstances of a conflict between the final determinations and additional subsequent material published by companies, the final determinations and any pre-acceptance clarifications will take precedence over any other documentation.

In relation to the points raised about the definition of performance commitments, the link between WTP and rewards/penalties and customers' views on rewards, we plan to address these as part of our broader work on the Water 2020 programme and in developing the outcomes framework for PR19.

Appendix 3: Wholesale water and wastewater costs and revenues

A3.1 Introduction

Within the wholesale water and wastewater controls there are three important incentives that will require reconciliation at the end of the 2015-20 period.

- Totex cost sharing and menus where companies out- and underperformance is shared between the company and its customers based on the company's menu sharing rate.

- The WRFIM, which provides a financial incentive to encourage companies to accurately forecast revenue and manage demand risks within the control period.

- Water trading incentives, which provide an incentive for companies to import and export water.

We deal with each of these mechanisms below.

A3.2 Totex cost sharing

In relation to **totex cost sharing**, we have identified a number of issues that need to be considered as part of the reconciliation rule book.

- **Definition of totex for the purposes of menu sharing.** Companies' reported totex will not be consistent with the totex allowances subject to cost sharing included in the final determinations. For example, pension deficit recovery costs might be included in companies' reported totex, but were not in the final determination allowances subject to cost sharing. Therefore, we will need to adjust companies' reported totex before the cost sharing calculations can be carried out.

- **Treatment of inflation.** The cost allowances in the final determinations (updated for menu choices) are set out in 2012-13 prices. So, the reconciliation needs to consider whether an adjustment is required so that these can be compared to companies' totex during the 2015-20 period.

- **Allocation of totex out-/underperformance to RCV and revenue.** Totex is split into money that is recovered as revenue during the current period (using the Pay as You Go – PAYG – rate) and that recovered over time (which is added to the regulatory capital value – or RCV). At PR19, the cost sharing with customers (for example, the proportion of costs the company can recover from customers) will need to be separated between that recovered as revenue over the next period and that which is added to the RCV.

- **Treatment of time value of money.** Totex out- and underperformance will be achieved during specific years in the 2015-20 period, but will only be shared with customers at the end of the period. The reconciliation needs to consider whether an adjustment is required to reflect the difference in the value of receiving/paying money when the totex out- or underperformance was achieved and when the sharing with customers is carried out by the company.

- **Treatment of taxation.** Whether the revenue and RCV adjustments that result from cost sharing with customers should receive an adjustment to take account of taxation at PR19 so that the companies receive the net impact of cost out or underperformance.

We consider each of these issues in turn below.

A3.2.1 Definition of totex for the purposes of menu sharing

At PR19, we will need to compare companies' reported totex with their allowed totex for the 2015-20 period to calculate out- and underperformance and cost sharing. For this comparison, we only need to consider the totex that is subject to cost sharing.

Our consultation document

Our consultation set out a series of adjustments that would be required to reported totex to determine totex for the purposes of cost sharing. We set out these adjustments in more detail in the draft reconciliation rulebook and associated spreadsheets.

Consultation responses

Most companies agreed with the definition of costs for exclusion from totex cost sharing, although some asked for greater clarity or proposed alternative definitions in some areas. The main issues raised were as follows.

- **Definition of fines.** United Utilities and Southern Water asked for more detail on the definition of fines, Southern Water suggested that only fines imposed under section 22a of the Water Industry Act 1991 or the Competition Act 1998 should be excluded.

- **Definition of operating expenditure (opex) recharges.** United Utilities, Southern Water and South East Water requested more detail on the definition of opex recharges (to adjust for the move from historical cost accounting to principal use accounting to allocate shared assets).

- **Definition of costs with no benefit.** Southern Water interpreted "costs with no benefit" as costs associated with a special cost factor claim that was not successful.

- **Pension cash contributions.** United Utilities asked whether the exclusion of pension cash contributions was limited to deficit contributions.

- **Market opening costs.** Northumbrian Water stated that the rulebook did not exclude wholesale market opening costs.

- **Energy market hedging costs.** Anglian Water stated that elements of energy hedging volatility should be excluded from totex.

- **Timing of decisions on totex exclusions.** Dŵr Cymru stated that we should wait until the new accounting guidelines have been further embedded before concluding on totex exclusions.

- **Adjustments to totex exclusions.** Sutton & East Surrey stated totex exclusions should be kept under review, with companies highlighting potential clarifications and Ofwat addressing the need for additional adjustments when implementing new reporting requirements.

Our decision

We welcome the broad support for the approach we have taken to totex exclusions. We have considered the issues that respondents raised and set out our response below. Further detail on totex exclusions are set out in the PR14 reconciliation rulebook and supporting spreadsheets. This will be built on in the regulatory accounting guidelines.

- **Definition of fines.** We do not consider that the definition of fines should be limited to those imposed under section 22a of the Water Industry Act 1991 or the Competition Act 1998 as this would mean that customers would bear some of the cost (through the cost sharing mechanism) of other fines – for example, fines for environmental pollution, which does not seem appropriate. But we do think that small fines could be included as they are de minimus. Therefore, we therefore consider that all fines above £1,000 should be excluded from totex for the cost sharing calculations.

- **Definition of opex recharges.** We agree that there would be benefit in further clarity in opex recharges and have included an example of the calculations in the PR14 reconciliation rulebook.

- **Definition of costs with no benefit.** We do not agree with Southern Water that "costs with no benefit" are costs associated with a special cost factor claim that is unsuccessful. Costs with no benefit are costs where the associated activity has no customer benefit, for example refinancing expenditure. We will provide further detail on this as part of the regulatory accounting guidelines.

- **Pension cash contributions.** Only defined benefit pension deficit contributions (including any elements of these contributions recover by recharges) should be excluded from actual totex (in line with the exclusions at PR14). We have updated the PR14 reconciliation rulebook to make this clear.

- **Market opening costs.** Only 2014-15 market opening costs were excluded from the menu, which will not be reported in totex in the 2015-20 period. All other market opening costs should be included in the menu.

- **Energy hedging costs.** As energy market hedging costs were included in totex baselines, we do not consider that hedging costs should be excluded from totex (unless they fall under the definition of totex with no benefit to customers). Companies could disclose energy hedging costs in their annual performance report narratives if they consider that it is a material issue.

- **Adjustments to totex exclusions.** The final determinations made it clear that some costs would be excluded from totex baselines. We consider that it is important to provide greater certainty to companies by providing further details on totex exclusions as part of the PR14 reconciliation rulebook. We will keep these definitions under review as part of the regulatory accounting guidelines.

A3.2.2 Treatment of inflation in totex cost sharing

The cost allowances in the final determinations (updated for menu choices) are set out in 2012-13 prices and the reconciliation needs to consider whether an adjustment is required so that these can be compared to companies' totex during the 2015-20 period.

Consultation document

Our consultation proposed the approach set out in our final determinations, which stated that:

> **"our intention for PR19 is that allowed expenditure will be left in 2012-13 prices, while actual totex will be deflated to the PR14 2012-13 price basis by actual RPI."**[10]

Consultation responses

There were 11 responses on this issue, with unanimous support for the proposed approach. Bournemouth Water asked for confirmation that we would be using financial year average RPI to deflate actual totex.

Our decision

We welcome the support for our proposed approach, and we confirm that **we will deflate actual totex by actual RPI for the calculation of totex cost sharing**. Actual RPI will be based on the financial year average.

A3.2.3 Allocation of totex out-/underperformance to RCV and revenue

Totex can be split into money that is recovered as revenue during the current period (using the PAYG rate) and that recovered over time (which is added to the RCV). At PR19, the cost sharing with customers will need to be shared between that recovered as revenue over the next period and that which is recovered over time.

[10] Page 44, 'Final price control determination notice: policy chapter A4 – reconciling 2010-15 performance'.

The choice of PAYG rate for the customer sharing of out- and underperformance can potentially have a material impact on the profile of future customer bills (with a higher PAYG rate leading to a larger immediate impact on future bills but a lower impact over the longer term).

Consultation document

We proposed that using weighted average PAYG rates from the PR14 price control[11] and applying these to the adjustments made at PR19, with companies needing to provide a clear justification that any divergence from this would be in customers' interests, would be the most appropriate approach. This was because of concerns over the impact on customer bills (either in the short or long term) if all the adjustment was made through revenue or RCV adjustments, and consistency with the PR14 totex approach, company business plans and customer preferences. We considered using a weighted average approach to calculate PAYG rates would avoid potential distortions in incentives from using average PAYG rates across the period and would provide a realistic baseline for companies to justify why a different PAYG rate would be in customers' interests.

Consultation responses

We received 14 responses on this issue, 13 of which agreed with the proposed position of using weighted average PAYG to allocate expenditure out- and underperformance. Bristol Water suggested while it agreed with the basic approach that more flexibility would be required. Bournemouth Water suggested that we should have regard to the forecast bill profile over 2020-25 to avoid unacceptable bill impacts.

Severn Trent Water disagreed with our proposed approach and suggested that we should use the annual PAYG rate to avoid distorting allocations.

[11] The weighted average is calculated by weighting the PAYG rate in each year by the allowed totex in each year.

Three companies (Seven Trent Water, South West Water and South Staffordshire Water) stated that the revenue adjustment associated with the additional incentive from the menu should be made through revenue rather than applying the PAYG rate as this would result in smoother customer bills.

Our decision

We do not agree with Severn Trent Water that using annual PAYG rates would avoid distortions. PAYG rates in individual year typically reflect company assumptions over the split of capex and opex in that year. If the profile of capex changes from that forecast then applying the same annual PAYG rates could distort the overall level of PAYG across the period for the same overall level of expenditure.

In response to the comments to Bristol Water, we consider that allowing companies to provide justification for a change away from default PAYG rates if it is in customers interests appears to provide companies with sufficient flexibility to address concerns, including over future bill profiles (also addressing Bournemouth Water's concerns).

So, we **continue to consider that using the weighted average PAYG rates, with company justification that a divergence is in customer interests, is the most appropriate approach**.

We agree with Severn Trent Water, South West Water and South Staffordshire Water that the revenue reward/penalty for out- or underperformance should be through revenue rather than applying the PAYG rate. We have amended the PR14 reconciliation rulebook and supporting spreadsheets accordingly.

Table A3.2 Assessment of options for the choice of PAYG rate for out- and underperformance

Criteria	Option 1: All allocated to revenue	Option 2: All allocated to RCV	Option 3: Use weighted average PAYG, with companies justifying divergence	Option 4: Allow companies to propose
Customer benefits				
Company financeability				

Criteria	Option 1: All allocated to revenue	Option 2: All allocated to RCV	Option 3: Use weighted average PAYG, with companies justifying divergence	Option 4: Allow companies to propose
Consistency with final determination and other relevant documents				
Risk of perverse incentives				
Company ownership and accountability				
Consistency with other reconciliation tools				
Straightforward and clear to implement				
Preferred option	×	×	✓	×

A3.2.4 Treatment of time value of money on totex sharing

Totex out- and underperformance will be achieved during specific years in the 2015-20 period, but will only be shared with customers at the end of the period. The reconciliation needs to consider whether a time value of money adjustment is required to reflect the difference in the value of receiving/paying money when the totex out- or underperformance was achieved and when the sharing with customers is carried out by the company.

Consultation document

We proposed that applying a time value of money adjustment was appropriate as there was a timing difference between when money was going to be paid out (or received) and when it would be reimbursed. This would also be consistent with the WRFIM, which provides a time value of money adjustment and would reduce the potential for perverse incentives as the adjustment would ensure that companies were neutral when cost savings (or increases) occurred.

Consultation responses

All of the 11 responses received on this issue supported our proposed approach to applying a time value of money adjustment. Two companies raised additional points.

- Severn Trent Water stated that there was an inconsistency between the time value of money adjustment in the totex model and other reconciliation issues (for example, the WRFIM).

- Thames Water asked for further clarity on how out-/underperformance would be profiled through AMP7 (2020-2025).

Our decision

We do not consider that the time value adjustment for totex is inconsistent with the approach used for other mechanisms. We have only included a time value of money adjustment where the timing of revenue recovery is likely to create material issues. We do not consider that the time value of money adjustment for totex is inconsistent with the approach used in the WRFIM. The WRFIM necessarily has a two-year delay between revenue is recovered and when it can be adjusted (as actual revenue recovery will only be known after the end of the year and so can only be reflected in the following years charges). The totex model calculates under- or overspending in individual years and then reconciles at the end of the period. For consistency across the reconciliation mechanisms we amended the totex model to reflect a full year of discounting, i.e.no half-year adjustment in the final year. This assumption will be reflected in the PR19 financial modelling.

In response to Thames Water's request for clarification, we do not consider that it appropriate to set out how revenue will be profiled in AMP7 as this is a decision to be taken as part of PR19, when the scale of adjustments becomes clear.

We therefore **continue to consider that Option 2, adjusting all totex out- and underperformance for the time value of money** is the most appropriate approach for the reasons set out above.

Table A3.3 Assessment of options for adjusting for the time value of money of totex out- and underperformance

Criteria	Option 1: No time value of money adjustment	Option 2: Time value of money adjustment	Option 3: Time value of money adjustment only for non-PAYG element
Customer benefits			
Company financeability			
Consistency with final determination and other relevant documents			
Risk of perverse incentives			
Company ownership and accountability			
Consistency with other reconciliation tools			
Straightforward and clear to implement			
Preferred option	×	✓	×

A3.2.5 Treatment of taxation on totex sharing

The revenue and RCV adjustments that result from cost sharing with customers could be made net or gross of taxation. A tax adjustment will tend to amplify the impact on customers – that is, it would increase the customer impact of any totex over spending (as an additional allowance for tax would be required) and reduce the impact of any totex underspending (as the reduction in revenue will reduce the amount required for tax).

Consultation document

While we recognised that the advantages and disadvantages of these approaches is finely balanced, we proposed that we should only include a tax adjustment for the customer share of the RCV element of totex out-/underperformance in PR19. We preferred this approach as it would:

- be simple to implement and would not require additional changes to RCV adjustments (where a tax allowance is automatically applied by the Ofwat price control financial model);
- maintain company incentives to outperform our financial determinations assumptions; and
- avoid providing a double allowance for tax on the revenue elements of the customer share of totex.

Consultation responses

We received 13 responses to this proposal. Six respondents agreed with the proposal and six disagreed. One company suggested that the options lacked transparency and that further thought should be given. The main issues that respondents raised were as follows.

- United Utilities, Bristol Water and CCWater expressed support for not providing an additional allowance tax (both on the revenue and RCV adjustments) – as this would be in the best interests of customers.

- Severn Trent Water and Affinity Water stated that incentives would be weakened or inconsistent if full allowances for tax were not included for both elements of the totex out-/underperformance.

- Bournemouth Water stated that the options were difficult to understand and lacked transparency. It suggested that it would be fairer to both companies and customers to reflect the full impact of any over-/underspend with a tax adjustment and that the issue should be discussed further.

Our decision

We have reconsidered whether it is appropriate to provide a tax adjustment for the customer share on the RCV element of totex out-/underperformance at PR19 based on the options set out in the consultation and summarised below.

Option	Description
Option 1	Include a tax adjustment for the customer share of totex out-/ underperformance in PR19.
Option 2	Do not include a tax adjustment for the customer share of totex out-/ underperformance in PR19.
Option 3	Only include a tax adjustment for the customer share on the RCV element of totex out-/underperformance in PR19.

As we set out in the consultation, we consider that each of the options has drawbacks.

The tax impacts of totex reconciliation are complex. To be able to understand these issues, we need to consider:

- the tax treatments of different types of expenditure in calculations that we used for PR14;
- the impact of over- and underspending on actual tax paid during the period; and
- the tax treatment we will adopt for totex reconciliations at PR19.

At PR14, companies received a revenue allowance for tax based on forecast taxable profits. All other things being equal, the greater the revenue requirement, the greater the taxable profit and the greater the revenue allowance we provided for the payment of tax. We took into account companies' actual and forecast tax capital allowances when calculating the amount of tax that we should allow in revenue limits.

During the control period, the higher the level of opex, the lower the likely profitability and therefore the lower the amount of tax paid (and vice versa). For capex, the greater the level of expenditure, the higher the capital allowance and so again tax would be reduced. However this reduction in taxation will be spread over the life of the asset – that is, used in the calculation of its capital allowance – rather than simply the year in which the expenditure was incurred.

Any over- or underspending during 2015-20 will be shared with customers during the period of the 2020-25 price control, based on the menu cost sharing rate. Adjustments will be translated into both revenue and RCV changes based on the PAYG rate. In developing our thinking on this issue, we made a simplifying assumption that the PAYG element of totex is broadly equal to the accounting opex. For the RCV element, we have assumed this is accounted for as capex.

Where opex overspends occur then there would need to be a reconciliation to increase revenue in the next period (to reflect the customer share of this overspending). If this revenue adjustment were to include an uplift for tax paid at PR19, then this would mean that the company would receive an additional tax allowance, despite paying less tax in the 2015-20 period because of the overspending. We do not consider that this is appropriate.

Where there has been additional capex spending in period (which flows through into a RCV adjustment), then this would increase the capital allowances claimed during the 2015-20 period (above our PR14 assumptions) – although the effect would be relatively small as capital allowances are claimed over the longer term. This smearing of capital allowances also means that any projections of capital allowances made at PR19 will be higher as the brought forward value of the capital allowance pools will be higher. As a result, while the company might have reduced its tax payments during the 2015-20 period, there will also be a reduction in tax paid during the next period, meaning lower revenue for companies and customer bills from 2020-21.

We appreciate that the situation is more complex than set out above, as the amount of over- or underspending going into the revenue and RCV adjustments will be based on the PAYG rate and not the split of opex and capex. However, given the smaller impact of capital spending on tax in the shorter run and the potential to take account of changes to capital allowances in the price control financial modelling, we are not convinced that it is appropriate to change our approach to the calculation of RCVs to finesse the tax treatment of totex reconciliations.

As a result, **we intend to retain Option 3 from the consultation and make no extra allowance for tax on the revenue adjustments that arise from PR14 totex reconciliations, but to allow for tax on the RCV adjustment** (where there is more or less taxable revenue from RCV return and run-off going forward). This retains the same approach to calculating tax allowances on RCV returns and run-off as used at PR14.

Table A3.4 Assessment of options for the treatment of tax in totex sharing

Criteria	Option 1: Adjust tax for customer sharing	Option 2:Do not adjust tax for customer sharing	Option 3: Only adjust for tax on RCV element
Customer benefits			
Company financeability			
Consistency with final determination and other relevant documents			
Risk of perverse incentives			
Company ownership and accountability			
Consistency with other reconciliation tools			
Straightforward and clear to implement			
Preferred option	×	×	✓

A3.2.6 Other issues on totex

Consultation responses

Companies also raised issues around the spreadsheet modelling, in particular:

- **ex ante incentives –** Severn Trent Water and South Staffordshire Water stated that the totex model made no adjustment for the ex ante additional income incentive from the totex menu; and
- **transition expenditure –** Anglian Water and Bristol Water stated that transition expenditure would be incurred in 2014-15, while the reconciliation model only allowed it to be input in the year 2015-16 to 2019-20. One company suggested that an entry cell should be provided for 2013-14 as well.

Our decision

We have considered the points raised on the totex reconciliation model.

- **Ex-ante incentives.** We agree that the model should reflect the ex-ante additional income incentive and have updated the model accordingly.

- **Transition expenditure.** We agree that transition expenditure will be incurred in 2014-15 and so have updated the reconciliation model accordingly. Transition expenditure should not have been incurred in 2013-14.

We have also considered the issue that there can be a difference between the implied and final menu choice. So, we have amended the model to reconcile the difference between the allowed revenue under the implied and final menu choice.

A3.3 WRFIM

We set out our approach to the WRFIM in the final determinations[12], including:

1. the treatment of inflation (where differences in revenues are indexed using lagged November to November RPI consistent with the setting of k); and
2. the time value of money (where an allowance for the time value of money is provided).

As part of the PR14 reconciliation rule book we consulted on a number of further issues.

- **Treatment of revenue from in-period ODIs** – which will affect the total revenue obtained by the three companies with the relevant licence modification (Anglian Water, Severn Trent Water and South West Water).

- **Treatment of taxation** – whether companies should receive an adjustment to take account of taxation in PR19 on the revenue adjustments that result from the WRFIM.

- **Treatment of the blind year in WRFIM** – where we consider how the WRFIM should be reconciled in PR19.

[12] Pages 51-55, 'Final price control determination notice: policy chapter A7 – risk and reward'.

In response to the consultation, some respondents raised concerns about the operation of the WRFIM and its consistency with the licence, and some more detailed technical issues around its operation. We have considered each of these issues in turn.

A3.3.1 The operation of the WRFIM

The WRFIM provides a financial incentive to encourage companies to accurately forecast revenue and manage demand risks within the control period. This involves the potential for a financial penalty for companies if there is more than a 2% difference between their recovered and their adjusted allowed revenues. The adjusted allowed revenues in the WRFIM include an adjustment to reflect previous revenue under- or over-recovery.

Responses to the rulebook consultation

Anglian Water, Severn Trent Water, Thames Water and Wessex Water stated that there was a potential issue with the operation of the WRFIM as the licence did not allow companies to aim to recover more in a year than set out in the price control. The WRFIM formula assumes that companies can increase (reduce) revenues above (below) those set out in the price control to make good for previous under- (over-) recovery. The WRFIM formula allows a penalty to be applied if collected revenues do not correct for previous under- or over-recovery and differences are above 2%.

Further consultation on the WRFIM

In response to these points, we issued a short consultation on a revised formula for WRFIM which did not apply penalties if companies had not made good for previous under-recovery. This continued to allow penalties to be applied if companies had not made good for previous over-recovery as we did not consider that this was in conflict with the licence.

Responses to the further consultation

We received representations from CCWater and 13 water companies. Respondents welcomed us highlighting the issue and carrying out an additional consultation. Six responses were supportive of the proposed revisions to the WRFIM formula. Six respondents raised objections to the use of the revised formula. Two respondents requested further clarification, in particular an illustrative spreadsheet.

The main objections to the revised WRFIM formula were that:

- it would create asymmetric incentives;
- it would create an unnecessary additional pressure on customer bills at the next price control; and
- it was inconsistent with the final determinations.

Some respondents suggested alternative amendments to the WRFIM formula.

- Northumbrian Water and United Utilities proposed removing the adjustments to allowed revenue for both over- and under-recovery, similar to the revenue correction mechanism (RCM) used in the last price control.

- United Utilities suggested that, if an asymmetric incentive is imposed, under- and over-recovery of revenues should be treated cumulatively when setting target revenues for calculating penalties.

Respondents suggested four options to allow the use of the original WRFIM formula (as set out in the final determinations) without conflicting with the licence conditions.

- **Ofwat's discretion to apply penalties.** South West Water stated that we had flexibility to decide whether to apply penalties that arose through the WRFIM formula as we had stated that companies would not be penalised if revenue variances were in customer's interests or could not have been avoided by management action.

- **WRFIM is an ancillary matter to the control and so is consistent with the licence.** South East Water and Wessex Water considered that revenue changes resulting from the use of WRFIM could fall within the definition of 'matters ancillary to the said control' under the licence and so charges could be set in excess of final determinations allowed revenue if they were in accordance with the WRFIM (or any other aspect of the price control).

- **Explanatory note.** Southern Water suggested that we could issue an explanatory note as part of the PR14 reconciliation rulebook, setting out how the licence condition should be interpreted.

- **Licence modification.** Five companies proposed that condition B of companies' licences could be amended to allow in-period adjustments to allowed revenue which result from WRFIM during 2015-20. This would give companies flexibility for bill smoothing during 2015-20 and address the concerns with the consistency with the licence.

Our assessment of potential options

We consider that there could be a conflict between the WRFIM formula and the licence. 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 which had over recovered revenue from choosing to set prices below the price control limit to offset this previous over recovery.

Our response to the points made by respondents is as follows.

- **Ofwat's discretion to apply penalties.** While we have stated that we would not apply the WRFIM formula in a mechanistic way, we stated that we would consider whether or not to apply penalties if companies provided suitable evidence to us that **"the circumstances driving the deviations concerned have been genuinely beyond the control of efficiently managed companies"**[13]. We do not consider that setting charges in accordance with WRFIM would be a circumstance beyond companies control which would allow us not to apply penalties. Consequently if we did not apply penalties in these circumstances we would effectively be altering the WRFIM formula, which is what the revised WRFIM formula is seeking to achieve.

- **WRFIM is an ancillary matter to the control and so is consistent with the licence.** We consider that it is too late to define WRFIM as a matter that is ancillary to the control, even if this was allowed by the licence.

- **Explanatory note.** Given our statutory duty to take enforcement action if we are satisfied that a company is in breach of its licence[14], subject to only limited

[13] Page 15, 'Consultation on the wholesale revenue forecasting incentive mechanism for AMP6'.
[14] Section 18 of the Water Industry Act 1991.

exceptions[15], we do not consider that it is appropriate to provide any blanket assurance that we would not take enforcement action if a company was in breach of its licence in seeking to recover previously under-recovered revenues with the 2015-20 period.

Therefore, we consider that our options are to either amend the WRFIM formula to avoid any inconsistency with the licence, or amend the licence to avoid any inconsistency with the WRFIM formula.

Potential change to the WRFIM formula

We could change the WRFIM formula by removing the penalty on companies if they do not make up previous under-recovery. This does not remove the need to reconcile over and under-recovery and apply a time value for money adjustment. This would involve the following changes to the WRFIM formula.

1. Breaking down the WRFIM adjustment into a main revenue adjustment term and a penalty term.

2. Defining a new term $AR^{*}{}_{\mathrm{t-2}}$ as the baseline for the calculation of penalties, which is the minimum of the allowed revenue (in year t -2) and the price control allowed revenue (in year t-2), to ensure that companies will not be penalised for compliance with their licences and thus not making up previous under-recovery, but could be penalised if they over recovered and did not make up the difference.

3. Updating the penalty rate calculation based on the new baseline, and this removes the revenue flexibility threshold (RFT) defined in the original formula, as the new definition of penalty rate does not require a separately defined RFT term (given the different form of the equation).

This results in the following formula to calculate the WRFIM.

[15] Section 19 of the Water Industry Act 1991.

$$\mathrm{RFIM_t} = -\left\{(\mathrm{RR_{t-2}} - \mathrm{AR_{t-2}}) \times \left[1 + \left(\frac{\mathrm{I}}{100}\right)\right] \times \left[1 + \left(\frac{\mathrm{I}}{100}\right)\right]\right\} \times (1 + \mathrm{RPI_{t-1}}) \times (1 + \mathrm{RPI_t}) -$$

$$\left\{\frac{PR}{100} \times |\mathrm{RR_{t-2}} - AR^{*}{}_{\mathrm{t-2}}| \times \left[1 + \left(\frac{\mathrm{I}}{100}\right)\right]\right\} \times (1 + \mathrm{RPI_{t-1}}) \times (1 + \mathrm{RPI_t})$$

Where:

$\mathrm{RR_{t-2}}$ The revenue recovered in charging year t-2, with the first year subject to the adjustment beginning in 1 April 2015

$\mathrm{AR_{t-2}}$ The adjusted allowed revenue in charging year t-2, with the first year subject to the adjustment beginning in 1 April 2015, and with the adjusted allowed revenue from the charging years beginning 1 April 2017 being adjusted by the WRFIM for that year. From year three onwards adjusted allowed revenues will be used to take account of penalties from prior periods.

$AR^{*}{}_{\mathrm{t-2}}$ The baseline to calculate penalties which will be the minimum of $\mathrm{AR_{t-2}}$ and the allowed revenue in charging year t-2 from the PR14 FD (in outturn prices).

I The specified discount rate, which enters the above formula as a number (rather than a percentage). The rate is the company wholesale cost of capital as set out in the final determination company specific appendix.

PR The penalty rate. Denoting the forecast error $(\mathrm{RR_{t-2}} - \mathrm{AR^{*}{}_{t-2}})/\mathrm{AR^{*}{}_{t-2}} = \mathrm{x\%}$, the penalty rate is: (i) 3% for all variations if $|\mathrm{x\%}| > 3\%$; (ii) $3\% * (|\mathrm{x\%}| - 2\%)/(3\% - 2\%)$ if $2\% < |\mathrm{x\%}| \leq 3\%$; (iii) zero if $|\mathrm{x\%}| \leq 2\%$. The result enters the above formula as a number. For example, for a penalty rate of 3%, PR enters the formula as number 3.

$\mathrm{RPI_t}$ the Retail Prices Index used for wholesale price controls for year t as specified in Condition B in the licence. The licence requires wholesale revenue controls to adjust by the percentage change in the RPI between the November in the current and previous years.

t the year of WRFIM adjustment.

The first part of the revised WRFIM formula is the main revenue adjustment. The main revenue adjustment is determined by calculating the difference between the recovered revenue to the adjusted allowed revenue in year t-2 and multiplying this by the time value of money adjustment (the cost of capital) and inflation (measured through the retail price index) between year t-2 and year t. This part of calculation is unaffected by the change in the WRFIM formula.

The second part of the revised WRFIM formula is the penalty calculation. This compares recovered revenue in year t-2 to the penalty baseline ($\mathrm{AR}^{*}{}_{\mathrm{t-2}}$). $\mathrm{AR}^{*}{}_{\mathrm{t-2}}$ is the minimum of the adjusted allowed revenue $\mathrm{AR}_{\mathrm{t-2}}$ and the price control allowed revenue. The term $\mathrm{AR}_{\mathrm{t-2}}$ will be above the price control allowed revenue if a company had under-recovered in prior year (as the adjusted allowed revenue would have been uplifted by the WRFIM formula). Consequently a company will not be penalised for not making up for previous under-recovery. The term $\mathrm{AR}^{*}{}_{\mathrm{t-2}}$ will equal $\mathrm{AR}_{\mathrm{t-2}}$ if a company had previously over recovered (and so the RFIM formula would lower adjusted allowed revenues so that they were below price control revenues). As a result, a company could still receive a penalty if it does adjust charges to compensate for previous over recovery of revenues.

We consider that adjusting the WRFIM formula in this way would remove the possibility that companies could be penalised for complying with their licence. However we note that this would have a number of potential implications.

- It would alter the WRFIM formula that was consulted on as part of PR14 and set out in the final determinations.

- It would create an asymmetric incentive as under-recovery would not be penalised by the mechanism in the same way as over-recovery. This could increase the risk of under-recovery although we do not consider that this should conflict with long term customer interests as under- and over-recovery will still be reconciled at the end of the period.

- It could compromise the WRFIM's policy objective of smoothing out customers' bill, as companies will only be incentivised to smooth out over recovery but not under-recovery.

Potential licence modification

We consider the other way to address the potential inconsistency between the licence and the WRFIM formula is to amend the licence. We consider that this would require an amendment to licence condition B. We set out an illustrative example of a possible amendment below.

For the avoidance of doubt, sub-paragraph [8.1/9.1[16]] 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 ($RFIM_t$) 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.

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

We consider that this licence amendment would have advantages over a change to the WRFIM formula in that it would maintain the symmetric incentives of the original WRFIM formula. It would also be consistent with the final determination documentation. However, a licence modification would require the consent of each company.

Further consideration

Based on the assessment outlined above, there appear to be three potential options.

- Use the revised WRFIM formula for all companies.
- Allow companies to choose between a licence amendment (and the original WRFIM formula) or no change to the licence (and the use of the revised WRFIM formula).
- Only introduce a sector wide licence modification if all companies agree to the proposed change.

[16] 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.

Therefore, we are interested in stakeholders' views on:

- the potential drafting for the licence modification;
- whether companies would support such a licence modification; and
- which of the options listed above we should pursue.

As noted in the overview, we would be grateful for views on these issues by **10 August 2015**.

A3.3.2 Treatment in WRFIM of revenue from in-period ODIs

In the final determinations, we agreed with the request from three companies (Anglian Water, Severn Trent Water and South West Water) that some ODIs could be paid during the 2015-20 period. These are referred to as in-period reward and penalties.

In-period rewards and penalties will affect the overall level of revenue obtained by the company and so could affect the calculations in the WRFIM. Our final determinations recognised this impact and stated that:

> **"when any such licence changes have been agreed we will discuss with the affected companies any consequential need to modify the terms of WRFIM as appropriate."**

Consultation document

We proposed to include in-period ODI rewards and penalties in the allowed revenues in the WRFIM calculations as it should be relatively straightforward, and this would ensure consistency across all companies and maintain incentives for companies to manage revenues within period and take in-period rewards and penalties.

Consultation responses

We received 13 responses supporting the proposal to including in-period ODIs in the allowed revenues that are inputs in the WRFIM formula. There were no objections to this approach. Respondents raised two additional issues.

- Bournemouth Water highlighted an inconsistency in the consultation document where it was unclear whether in-period ODIs would be included or excluded from the formula.

- Dŵr Cymru noted that this approach could be extended for a number of other cases – for example, support for social tariffs which are part-funded by companies in the form of voluntary revenue abatements and in-period adjustments for the RCM true-up of the PR09 blind year (2014-15).

Our decision

We have considered the issues that consultees raised.

We confirm that the intention of the consultation was to include revenues from in-period ODIs in the allowed revenues in the WRFIM calculations.

One of the objectives of the WRFIM mechanism was to incentivise companies to better manage their revenues during the control period. While we agree with Dŵr Cymru that as social tariffs are part funded by companies, it would be incorrect that companies are either penalised for providing social tariff or that voluntary revenues forgone through social tariffs are reclaimed at the next periodic review. So, we propose that companies' part funding of social tariffs is excluded from WRFIM[17].

We do not consider that the true-up for the blind year in the PR09 revenue correction mechanism should be excluded from WRFIM as the correction will not occur until PR19.

Based on the reasons set out above and taking into account the support from responses to the consultation, **we will include ODI rewards and penalties in the allowed revenues in the WRFIM calculations**.

[17] This is consistent with the approach used for the revenue correction mechanism in 2010-15 where we did not allow the recovery of a revenue shortfall from 'lower tariffs' because this should be funded by company shareholders. See page see page 4 of http://www.ofwat.gov.uk/publications/prs_in1004rcmsupp.pdf

Table A3.5 Assessment of options for the treatment of in-period ODI rewards and penalties in WRFIM

Criteria	Option 1: Adjust allowed revenues for in-period ODIs	Option 2: Do not adjust for in-period ODIs
Customer benefits		
Company financeability		
Consistency with final determination and other relevant documents		
Risk of perverse incentives		
Company ownership and accountability		
Consistency with other reconciliation tools		
Straightforward and clear to implement		
Preferred option	✓	×

A3.3.2 Treatment of taxation in WRFIM

The WRFIM framework will allow over- or under-recovery of allowed revenue to be taken into account through a true-up mechanism in PR19. We did not set out in our final determinations whether this true-up would take account of taxation in PR19 on the revenue adjustments that result from the WRFIM.

Consultation document

We proposed not to provide a tax allowance for changes due to WRFIM as the revenue allowances for the 2015-20 period already included an allowance for tax which is payable on those revenues.

Consultation responses

We received 13 responses to the tax adjustment proposal. Ten respondents agreed with the proposal and three disagreed.

- Severn Trent Water considered that not providing a tax adjustment could lead to customers paying twice for taxation.

- Thames Water were concerned that the proposed approach places companies at risk of tax rate changes.

- Affinity Water considered that the proposed approach did not treat over and under-recovery of revenues equally.

Our decision

We have considered the issues that respondents raised.

- **Double recovery of taxation allowances.** We do not agree that our proposed approach would provide a double recovery of taxation allowance. If a company over-recovered revenue during 2015-20, then it would pay more tax. At the next price control, it would receive a revenue reduction equal to the over recovery – but we would not take this reduction in revenue into account in calculating its tax allowance. So in effect, it would receive a higher tax allowance for 2020-25 than its actual tax charge – but only (broadly) compensating for the extra tax paid in 2015-20. The opposite would be true if the company under-recovered revenues.

- **Differences between ex ante and ex post tax rates.** Consistent with the approach used for other reconciliation mechanisms, we consider that companies will benefit from reductions in corporation tax during the period, we therefore do not consider that we should protect companies from changes in the tax system which will impact on the allowances set at the next review.

- **Equal treatment of under- and over-recovery.** We consider that not applying a taxation adjustment provides equal treatment to over- and under-recovery of revenues. If a company under-recovered revenue in period, it would pay less tax. The tax allowance at the next control period would not be adjusted upwards to reflect additional revenue – so compensating for the tax saving made in 2015-20. As a result, both under- and over-recovery of revenues would be treated equally.

Based on the reasons set out above, **we continue to consider that we should not provide a tax allowance for adjustments related to WRFIM** at the next price control period.

Table A3.6 Assessment of options for the treatment of tax in WRFIM

Criteria	Option 1: Adjust tax for WRFIM	Option 2: Do not adjust tax for WRFIM
Customer benefits		
Company financeability		
Consistency with final determination and other relevant documents		
Risk of perverse incentives		
Company ownership and accountability		
Consistency with other reconciliation tools		
Straightforward and clear to implement		
Preferred option	×	✓

A3.3.3 Treatment of blind year

Our final determinations stated that the over- or under-recovery of allowed revenue will be applied through a true-up mechanism at PR19[18]. The revenue adjustment for WRFIM is derived with a two-year lag. Therefore, the true-up will be relevant to the last two years of the 2015-20 period (2018-19 and 2019-20). While the actual revenue collected for 2018-19 will be known at the time of the PR19 determination this will not be the case for 2019-20.

Consultation document

In the consultation, we proposed that, if a company's licence did not allow an adjustment during the 2020-25 period, an estimate should be made for the blind year (2019-20) in the PR19 determinations. We considered that this would reduce the scale of adjustment required in PR24 and maintain a more direct link between company performance and bills.

[18] Page 54, 'Final price control determination notice: policy chapter A7 – risk and reward'.

Consultation responses

We received 13 responses to the proposal on treatment of blind year. Eleven agreed with the proposal and two (Severn Trent Water and Thames Water) disagreed. Both companies that disagreed with the proposed approach did not consider there was a need for a blind year adjustment as it was unlikely companies would forecast that revenues that did not match their allowed revenues in 2019-20.

Our decision

As we cannot rule out significant differences between allowed and actual revenues in the blind years, we should have agreed mechanisms in place to deal with these eventualities. Therefore, **we confirm that, if a company's licence does not provide an adjustment during the 2020-25 period, an estimate should be made for the blind year (2019-20) in the PR19 determinations.**

A3.3.4 Other issues raised in responses to the consultation

As summarised below, we received a number of representations requesting for clarifications on issues linked to the WRFIM.

Definition of recovered revenue

Some responses requested additional clarity around the definition of recovered revenues for inclusion in the WRFIM.

Recovered revenue is wholesale charge revenue for water/ wastewater in the Annual Performance Report, see RAG 3.08 pro forma 2I – 'Total revenue governed by wholesale price control (row 38 columns C and D). This reference may change if the RAGs are updated after 2015-16.

Revenue for new connections

Wessex Water requested further clarity over whether it can request additional revenue for new connections as was stated in its final determination.

We note that as we set out in our final determinations:

> **"if a company increased revenue by unduly reducing connection charges we may take corrective action to ensure that companies returned these monies (with financing costs) to customers. Similarly, although we have decided not to allow automatic adjustments to allowed revenues for demand variations in**

> **wholesale controls, if demand for connections is unexpectedly high then we would nevertheless consider allowing extra revenue to compensate for the loss of price control revenue on a case-by-case basis."**[19]

In addition, we confirm our statement in Wessex Water's company specific appendix that:

> **"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 reconciliation, consistent with the approach set out [above]."**[20]

Use of November RPI

South West Water and Yorkshire Water stated that the reconciliation should use average RPI rather than November RPI in the calculation of WRFIM and Wessex Water requested further clarity on the approach to indexation.

We **confirm that November RPI will be used for the value of time adjustments to both allowed revenues and WRFIM penalties**. This is consistent with the final determinations and is consistent with the way that allowed revenues are adjusted within a control period and so is an appropriate basis for comparison.

Compounding effect of penalties

Dŵr Cymru raised a concern about the unintentional compounding effect of penalties.

We consider that it is the intention within WRFIM that allowed revenue in one period would reflect the impact of adjustments including penalties from previous periods. Consequently we confirm that the compounding effect of penalties is intentional although we note that the effect of the penalty compounding is unlikely to be material (as a penalty on a penalty would only represent an impact of 0.09% of revenue (3% times 3%).

[19] Page 47, 'Final price control determination notice: policy chapter A3 – wholesale water and wastewater costs and revenues'.
[20] Page 28, 'Final price control determination notice: company-specific appendix – Wessex Water'.

A3.3.5 Thames Tideway Tunnel (TTT)

Thames Water's revenue from its charges to customers from providing wastewater services comprises the following three components.

1. Revenues attributable to Thames Water's non-TTT wholesale wastewater revenue control.

2. Revenues attributable to Thames Waters' TTT wholesale wastewater revenue control.

3. Revenues attributable to Infrastructure Provider (IP) charges paid to the IP by Thames Water.

In the final determinations, we set separate revenue controls for 1 and 2. For 3, the revenue requirement of IP charges is set by the IP licence, and Thames Water will collect this revenue as a component of the total revenues from its wholesale wastewater charges to customers and pass the revenue through to the IP.

Consultation document

For Thames Water's wastewater service, we proposed that the WRFIM covers all three of these components in line with the position at final determinations[21]. Variations in annual wholesale revenues which arose from the separate incentives and obligations on the different components of the total charge revenues would be subject to the general WRFIM representation process if Thames Water considered these to be beyond its control.

Consultation responses

Thames Water stated that the allowed revenue and revenue recovered related to the TTT IP should be excluded from the calculation of WRFIM model as:

[21] This is proposed in page 39 of Thames Water's draft determination, and the final determination makes no changes to it:
http://www.ofwat.gov.uk/pricereview/pr14/det_pr1408draftappendixriskandreward.pdf

- IP revenues do not form part of Thames Water's regulated price control, whereas WRFIM incentivise revenues collected to align to the allowed revenue set in the price control;
- IP revenues are subject to a separate in-period revenue true-up mechanism, to reflect the specific risks associated with the collection of these revenues; and
- the exclusion of IP revenue from WRFIM can prevent unintended consequences such as double-counting, for example revenue under-recovered in a particular year may be recovered twice from customers through both the WRFIM (at PR19 true-up) and the IP licence in-period catch-up provisions.

Our decision

We agree with the points raised by Thames Water. We will therefore exclude IP charges from WRFIM.

A3.4 Water trading incentives

PR14 included incentives for new exports and new imports during the price control period. We consulted on the following three aspects of the water trading incentives.

- The export incentive.
- The import incentive.
- The application of inflation, time value of money and taxation to the water trading incentives.

A3.4.1 The export incentive

The export incentive applies to all new qualifying exports that start during 2015-20. We will allow exporters to retain 50% of the lifetime economic profits (that is, the

profits over and above the normal return on capital invested)[22]. The lifetime of the export could last beyond the end of 2015-20.

Consultation document

In the consultation, we explained that there are different ways in which we could interpret our PR14 methodology in relation to the amount of the export incentive payment to be received at PR19.

Our preferred option for the export incentive was Option 2b (export incentive payment at PR19 equal to 50% of the full discounted economic profit for the forecast life of the export with a cap of 100% of the economic profit for the years the export operates in 2015-20). Any amount beyond the cap would be rolled forward to the next price control. We considered this struck the right balance between incentivising new exports and making customers pay in 2020-25 for benefits which might arise many years after that period.

Consultation responses

We received 15 responses on the export incentive. Eleven respondents supported our proposed Option 2b and one respondent disagreed.

The main comments on our proposal were as follows.

- **Impact on incentives.** Thames Water considered the design of the export incentive leads to weak incentives towards the end of AMP6 and proposed we changed the approach to the cap on the export incentive payment. South East Water commented that the export cap delays incentive payment.

- **Clarity of operation of export incentive.** Sutton & East Surrey Water commented that a worked example of the export incentive would be helpful. Severn Trent Water commented that we need to be clear how economic profit will be calculated.

[22] See page 24 of our PR14 methodology statement http://www.ofwat.gov.uk/pricereview/pr14/pap_pos201307finalapproach.pdf

- **Timing.** Northumbrian Water commented that discussions over the award of the bulk supply incentives could be concluded earlier than PR19.

- **Cap.** United Utilities suggested that we should set the export incentive cap at 1% of water service turnover.

Our decision

Our response to the comments raised by respondents is as follows.

- **Impact on incentives.** We do not consider that incentives should weaken towards the end of the period. The export incentive remains at 50% of the full discounted economic profit for the forecast life of the export whenever the new export starts in 2015-20. The cap only affects the balance between what is paid at PR19 and what is paid in later price reviews.

- **Clarity of operation of the export incentive.** We have included an example of the operation of the export incentive and the calculation of economic profit in the PR14 reconciliation rulebook spreadsheet model.

- **Timing.** The PR14 methodology requires the export incentive to be paid at PR19 so that we can be assured that we only make export incentive payments to exports which comply with Ofwat-approved trading and procurement codes. However, a company can seek approval for its trading and procurement code ahead of PR19 which is a necessary condition for being awarded an export incentive.

- **Cap.** We consider that it is most appropriate to link the export incentive payment cap at PR19 to the specific profitability of the new export. For relatively small exports the alternative suggestion of a 1% of water service turnover cap would allow customers to pay in 2020-25 for benefits which might arise many years after that period.

For the reasons set out in the consultation and summarised above, and taking into account the support from responses to our proposed approach, we confirm that **we will adopt Option 2b for PR14 reconciliation – that is, the export incentive payment at PR19 will be equal to 50% of the full discounted economic profit for the forecast life of the export with a cap of 100% of the economic profit for the years the export operates in 2015-20**.

Table A3.7 Assessment of options for the amount of the export incentive at PR19

Criteria	Option 1: 50% of the economic profit for 2015-20	Option 2a: 50% of the full discounted lifetime economic profit	Option 2b: option 2a with a cap of 100% of the economic profit for 2015-20	Option 3: delay payment until the end of the export
Customer benefits				
Company financeability				
Consistency with final determination and other relevant documents				
Risk of perverse incentives				
Company ownership and accountability				
Consistency with other reconciliation tools				
Straightforward and clear to implement				
Preferred option	×	×	✓	×

A3.4.2 The import incentive

The PR14 methodology explained that we would be introducing a new import incentive.

Consultation document

We explained that our preferred approach was that qualifying imports will benefit from an import incentive of 5% of the costs of water imported under new agreements. New agreements will be defined in a company's Trading and Procurement Code. The company will have to show that its import complies with an Ofwat-approved Trading and Procurement Code before an import incentive payment is made. The company will have to provide sufficient evidence of the costs of the water imported under new agreements.

We also explained that import incentive payments will be subject to a cap of 0.1% of the importer's water activity turnover in any year of the control period[23]. We therefore considered that the import incentive payments are accrued annually during 2015-20 with the cap applying in each year.

Consultation responses

We received seven responses on the import incentive. Four respondents supported our preferred approach and one respondent disagreed.

The main comments on our preferred approach were as follows.

- Sutton & East Surrey Water stated that it remained unconvinced that there needs to be an import incentive.

- South East Water commented that we need to clarify what water activity turnover refers to.

Our decision

Taking account of the generally supportive responses, we confirm that we will adopt the approach set out in the consultation – **that is, qualifying imports will benefit from an import incentive of 5% of the costs of water imported under new agreements and import incentive payments will be subject to a cap of 0.1% of the importer's water activity turnover in any year of the control period**.

Our response to the specific comments by respondents to our preferred approach is as follows.

- **Need for an import incentive.** We consulted widely with stakeholders about options for encouraging water trading ahead of our PR14 methodology. The result was that we considered an import incentive was necessary to try to "kick start" water trading.

[23] See page 24 of our PR14 methodology statement http://www.ofwat.gov.uk/pricereview/pr14/pap_pos201307finalapproach.pdf

- **What "water activity turnover" refers to.** Our intention is that water activity turnover refers to the sum of "revenue from charges" and "other revenue" in Pro Forma 2A of Regulatory Accounting Guideline (RAG) 3.08.

A3.4.3 Adjustments for inflation, time value of money and taxation

To finalise our approach to water trading incentives, we need to decide the most appropriate approach for indexation, time value of money and taxation in relation to the export and import incentives.

Consultation document

We proposed applying an inflation and time value of money adjustment for the export and the import incentive. This was primarily because the export incentive is to be paid out for the duration of the export, which could be over 20 years, some form of discounting will be required to calculate the incentive. We considered that the discounting should involve adjusting for both inflation and the time value of money, consistent with the adjustments made for totex. We considered it was appropriate to apply the same treatment of indexation of inflation and the time value of money to the import incentive as we plan to do for the export incentive.

In relation to tax, we proposed a tax allowance on the export and import incentive consistent with the approach taken for ODIs and a post-tax regulatory framework.

Consultation responses

We received six responses which mentioned the inflation, time value of money or taxation treatment of ODIs. Five respondents support our preferred approach on all three issues and one respondent supported our preferred approach to inflation and the time value of money. No-one disagreed with our preferred approach to indexation, the time value of money or tax.

Our decision

Given the broad support for our consultation proposals, we intend to implement these as set out in the consultation and summarised in the table below.

Table A3.8 Preferred approach for inflation, time value of money and taxation for the export and import incentives

Issue	Export incentive	Import incentive
Inflation	The export incentive should be adjusted for inflation to the base year of PR19.	The import incentive should be adjusted for inflation to the base year of PR19.
Time value of money	The export incentive should be adjusted for the time value of money.	The import incentive should be adjusted for the time value of money.
Taxation	Provide a tax allowance	Provide a tax allowance

Appendix 4: Reconciliation of PR09 incentives

The final determinations included the reconciliation for the incentives set in PR09. The PR14 reconciliation will need to ensure that any outstanding issues related to these reconciliations are addressed as part of the PR19 final determinations.

We consider that there are four issues related to the reconciliation of the PR09 incentives that need to be addressed in PR19.

- **The indexation of the CIS RCV adjustment**, where in the final determinations we identified that a different RPI series had been used for the RCV and financing cost adjustment.

- **The blind year adjustment for the PR09 incentives**, where actual data for 2014-15 was not available at the time of the PR14 final determinations and we stated we would take a proportionate approach (for example, applying materiality thresholds where appropriate) to any subsequent adjustment in PR19.

- **The Construction Output Price Index (COPI) index used in the CIS model**, which in the PR14 final determinations was based on a mixture of the published COPI index and company forecasts, which will need to be updated as part of the adjustment for PR19.

- **The treatment of any updated values in the PR19 review** in terms of indexation, time value of money and taxation.

We consider each of these in turn below.

A4.2 Indexation in the CIS RCV adjustment

In the final determinations, we stated that we would consult on an alternative approach to the PR09 CIS RCV adjustment. We discussed the issue in our consultation document and set out our proposal to adjust the RCV in PR19. The proposed adjustment to the RCV would affect all companies. This includes Bristol Water, whose price determination appeal to the CMA is still ongoing. During the process for the Bristol Water's appeal to the CMA on its price determination, the CMA indicated that the CIS adjustment was relevant to the final determination and so was an issue that they would have to consider in the reference.

The CMA subsequently stated in its provisional findings that:

> **"We provisionally find that given the circumstances and the limited materiality of the issue for Bristol Water (relative to other areas of investigation), it would be prudent to allow Ofwat to conduct its industry wide process without further intervention from us."**[24]

We support the CMA's latest position on the CIS issue but note that these are only provisional findings. Bearing the provisional nature of these findings in mind we do not intend to reach a conclusion on the CIS issue until later in the year after the CMA's process has ended.

A4.3 Blind year reconciliation: use of materiality thresholds

The final determinations were based on estimates for company performance in the blind year, 2014-15, where full details of companies' actual performance was not available.

The blind year applies to the following mechanisms[25].

[24] Paragraph 8.41, CMA provisional findings, 10 June 2015.
[25] A blind year adjustment is not required for the service incentive mechanism (as this did not consider performance in 2014-15) or the operating expenditure incentive allowance (as this is based on whether a company has been able to outperform against its regulatory assumptions in 2013-14).

Incentive mechanism	Purpose	Revenue or RCV adjustment
Revenue correction mechanism (RCM)	Provides companies with a financial incentive to encourage customers to use water efficiently and to correct for differences between actual revenue collected and our assumptions for allowed revenue at the PR09 final determinations	Revenue
Capital expenditure incentive scheme (CIS)	Provides companies with an incentive for both cost outperformance and accurate capital expenditure business plans.	RCV and revenue
Change protocol (logging up and down, shortfalls)	Ensures the price control takes account material changes in delivery. Included in CIS model.	RCV and revenue
2009 agreed overlap programme	Allows funding of PR09 projects planned to overlap regulatory periods. Included in the CIS model.	RCV and revenue
Serviceability shortfalls	Recovers allowed capital costs from companies (through a reduction in the RCV) in the event the serviceability indicators deteriorate	RCV
Land sales	Recovers 50% of the net proceeds of qualifying land sales through a deduction from the RCV	RCV

The final determinations stated that:

> **"A final reconciliation of the mechanisms will be undertaken in the summer of 2015 to take into account companies' actual performance and expenditure in 2014- 15 (with the CIS being reconciled in 2016). In carrying out this reconciliation we will take a proportionate approach (for example, applying materiality thresholds where appropriate) to making adjustments for company's actual performance and implement these changes at the next wholesale price control review in 2019."**[26]

[26] Page 7, 'Final price control determination notice: policy chapter A4 – reconciling 2010-15 performance'.

Consultation document

We proposed that we should apply a materiality threshold to each of the relevant PR09 incentives mechanisms using a threshold of +/-2% of service turnover (2014-15) for all revenue adjustments and +/- 0.5% of company opening RCV (2014-15) for all RCV adjustments. We considered that this approach would ensure that all impacts are considered in the round and take into account offsetting effects, would be proportionate as adjustments would only be made if they were material and would be consistent with the approach set out in the final determinations.

Consultation responses

We received 16 responses in relation to applying a materiality threshold to the blind year adjustments. Eight respondents agreed and eight respondents disagreed with our proposed approach to apply a materiality threshold in aggregate. The main issues raised by respondents disagreeing with our proposed approach were:

- our assessment of the options shows that more criteria are met if no materiality threshold is applied;
- applying materiality thresholds for these final set of adjustments would not be consistent with application of adjustments in the final determination, which were not subject to any materiality tests, and were applied in full; and
- the inclusion of a materiality threshold is unnecessary and adds complexity.

Our decision

We have reconsidered whether it is appropriate to apply materiality thresholds to blind year adjustments. We note companies concerns but also recognise that an equal number of companies supported our proposed approach.

Therefore, we have decided **to retain a materiality threshold but to reduce it such that we avoid applying the most minor adjustments which in total are less than £10,000 by service**. We consider this approach is appropriate as it:

- maintains consistency with our final determinations statement of policy of taking a proportionate approach to these adjustments; and
- will ensure that the large majority of adjustments are likely to be made at PR19, so companies and customers are not disadvantaged by the use of a materiality threshold.

We consider that this approach is consistent with our assessment criteria, which place significant weight on consistency with the final determinations.

To be consistent with the principle of company ownership and accountability, we consider that companies should submit their proposed adjustments for the blind year, together with their assessment of whether these adjustments in aggregate meet the £10,000 materiality threshold by service.

Table A4.1 Assessment of options for the blind year adjustment

Criteria	Option 1: No materiality threshold	Option 2: Materiality threshold in aggregate	Option 3: Materiality threshold applied individually
Customer benefits			
Company financeability			
Consistency with final determination and other relevant documents			
Risk of perverse incentives			
Company ownership and accountability			
Consistency with other reconciliation tools			
Straightforward and clear to implement			
Preferred option	×	✓	×

A4.4 COPI updates for the CIS model

The CIS reconciliation models require COPI actuals to calculate the blind year adjustment[27]. Publication of the series used in the CIS reconciliation had been

[27] The serviceability models use forecast COPI at the time of the PR09 review and so are unaffected.

suspended after the quarterly index release in September 2014, while the methodology for calculating COPI is under review by the Office for National Statistics (ONS) following the transfer of the index from the Department of Business Innovation and Skills (BIS) to the ONS on 1 April 2015.

In the consultation, we stated that the situation with the COPI index created a number of risks for the CIS reconciliations.

- There is a risk that 'firm' indices will not be available within the timetable required to reconcile the PR09 mechanisms.
- There is a risk of unanticipated consequences which arise when the index is potentially revised or rebased.
- There is a risk that the COPI index is discontinued requiring the formulation of an alternative adjustment.

Consultation document

In the consultation, we proposed that we should adjust COPI in the CIS models when updated data becomes available. This would avoid the risk of perverse incentives from relying on company forecasts and would be consistent with the final determinations and other relevant documents[28]. The COPI should be updated in 2016 and so would be based on published figures rather than company forecasts.

Consultation responses

We received 15 responses to the options for the update to COPI. Thirteen respondents agreed with the proposal (of which four attached some conditionality) and two respondents (Yorkshire Water and South Staffordshire Water) raised objections.

Despite most respondents agreeing to the proposed approach, a number of concerns were raised, including:

[28] For example, Information notice IN 12/08 addresses frequently asked questions on CIS and RCM, where one of the topics concerned the availability of COPI data.

- uncertainty over how the COPI indices, including historical values, would be revised given the review ONS has under way;
- the possibility that the COPI series is discontinued; and
- the impact a new COPI index would have on existing calculations.

Because of these concerns, Yorkshire Water considered that we should leave the 2010-13 period as closed as these years within the CIS reconciliation were calculated using published and firm index values. For the final two years of the 2010-15 control period, Yorkshire Water suggested that we should apply inflation from the new published COPI index when it is published and the published values become final. South Staffordshire Water went further and stated that if a new COPI index was published then it should not impact on the CIS adjustments for 2010-14 where previously published data has already been used.

Anglian Water suggested, if the new COPI series was not well aligned to the previous published series then this may require further consultation between Ofwat and companies.

Our decision

We have considered the issues raised by respondents.

- Changes to CIS adjustments calculated using previously published COPI. We consider that it is appropiate for us to confirm that we will continue to use the previously published COPI figures for 2010-13 as this retains the published and firm COPI figures used in our final determinations. For 2013-14, where only the first quarter COPI value was firm, we do not consider it appropriate to make this commitment at this stage.

- Consultation following publication of new COPI series. We consider that, if there are material changes to the calculation of the COPI index that impacts on the growth trend in COPI, that we should reconsult on the appropiate way to work the new COPI series into the CIS reconciliation model before this is finalised.

We note that while the ONS is currently researching a new methodology for COPI, it has introduced a temporary solution, which was published for the first time in June 2015[29]. The implied output price indicators have been revised back to the beginning of 2014. These statistics are being released for the first time as experimental and are intended as a short-term solution only, while long-term development is ongoing by ONS. Given these uncertainties, it would be premature to adopt the temporary solution for the CIS reconciliation.

Based on the reasons set out above and the support to our proposed approach, we consider that we should retain our proposed approach to update COPI in 2016 when the updated index is available. We note that we may need to make an adjustment to convert from any new COPI index to an index that is consistent with the COPI index used at PR14 (for example, if there is a series break in COPI).

We will provide an update on the timing of any company submissions on the CIS adjustment when we conclude on the CIS RCV adjustment later in the year.

Table A4.2 Assessment of options for the update to COPI

Criteria	Option 1: Revise in 2016 when ONS issues revised COPI	Option 2: Revised in June 2015 using company forecasts	Option 3: Revise in June 2015 with blended forecasts
Customer benefits			
Company financeability			
Consistency with final determination and other relevant documents			
Risk of perverse incentives			
Company ownership and accountability			

.[29] ONS Interim solution for construction output price indices, quarter 1 (January to March) 2015

Criteria	Option 1: Revise in 2016 when ONS issues revised COPI	Option 2: Revised in June 2015 using company forecasts	Option 3: Revise in June 2015 with blended forecasts
Consistency with other reconciliation tools			
Straightforward and clear to implement			
Preferred option	✓	×	×

A4.5 The treatment of PR09 reconciliation adjustments in the PR19 review

The revenue and RCV adjustments that result from the reconciliation of 2010-15 performance including actuals for the 2014-15 blind year, will need to be adjusted for use in the PR19 review – for example, in terms of:

- indexation;
- time value of money; and
- tax treatment.

Consultation document

We proposed that these adjustments are carried out consistently with those made for the PR09 reconciliation and where relevant the PR14 adjustment, in particular:

- indexation of the adjustments resulting from the reconciliations will be undertaken based on actual RPI; and
- time value of money adjustments will be made only for all adjustments to take account of the difference between the timing in the adjustment. This includes the Thames legacy billing system shortfall.

Taxation treatment will be the same as for PR14, in that all adjustments will get a tax adjustment.

Consultation responses

We received three responses on the treatment of PR09 reconciliation adjustments in the PR19 review. All three respondents agreed with our treatment of these adjustments as detailed above.

Our decision

We will follow our proposed approach to carry out these adjustments consistent with their treatment in the PR09 reconciliation and where relevant the PR14 adjustment.

Appendix 5: Household retail

A5.1 Introduction

The household retail control sets total allowed revenue based on forecast customer numbers at the beginning of the price control period 2015-20. The total allowed revenue is then adjusted in each year by a modification factor multiplied by the difference between forecast and actual customer numbers by customer type (measured and unmeasured, water only, wastewater only and combined). The forecast customer numbers and modification factors are set out in each company's final determination.

We have considered whether there should be a reconciliation for customer numbers and revenues.

If a reconciliation is appropriate, then we will need to consider how this reconciliation should be treated in PR19 in terms of the treatment of time value of money and taxation. The treatment of indexation is not relevant to household retail controls as the controls are set in nominal prices.

A5.2 Reconciliation of household retail control

The modification factors are based on actual customer numbers. However, these will not be known by the company when it is setting the charges for each year, which could result in differences between outturn and allowed revenue. In addition, the allowed revenue control does not provide for an adjustment if a company over- or under-recovers the allowed revenue per customer.

Consultation document

In the consultation, we considered that **a revenue wash-up at the end of the period is the most appropriate approach** as it would avoid the risk of perverse incentives, provide companies with responsibility for managing revenues during the

control period and would be consistent with the final determinations in that it did not require a complex reconciliation mechanism[30].

Consultation responses

We received 13 responses to this issue. Ten respondents agreed with the proposal to include a revenue wash-up. Two respondents disagreed.

- Portsmouth Water and Sutton & East Surrey Water did not see the need for a mechanism as actual revenues should equal allowed revenues if customer charges are set correctly.

South Staffordshire Water stated that it did not see the need for a household retail incentive mechanism, although it did not comment directly on the wash-up proposals.

In addition, while supporting the proposal Bristol Water stated the reconciliation should be carried out in full in PR19 rather than waiting for the blind year to be adjusted in PR24 as any differences are likely to be small.

Our decision

We have considered each of the issues raised by respondents.

- **The need for a mechanism.** We continue to see the need for a wash-up mechanism for household retail. We consider that actual household revenues can differ from allowed revenues for a number of reasons, for example the structure of household charges.

[30] The consultation on the wholesale revenue forecasting incentive mechanism presented two options for reconciling household retail. A wash-up at the end of the period and the same form of incentive mechanism as applied to wholesale revenues (see pages 25 to 27). In the draft determinations we stated that our preference was for option 1, although the discussion was focused on whether a revenue forecasting incentive would apply rather than whether a wash-up would be introduced (see page 50, 'Draft price control determination notice: technical appendix A6 – risk and reward)'.

- **Introduction of a household retail forecasting incentive mechanism.** We consider that a wash-up mechanism would avoid the complexities of a forecasting incentive mechanism but protect customers where there are differences between allowed and actual revenues.

- **Reconciliation of the blind year.** While we agree with Bristol Water that if differences are likely to be small then it may be possible to carry out the reconciliation in full in PR19, we consider that this decision should be made in PR19 when the scale of likely differences can be identified with more accuracy.

Based on the reasons set out above and the strong support from respondents, we continue to consider that **a revenue wash-up at the end of the period is the most appropriate approach.**

Table A5.1 Assessment of options for the reconciliation of household retail revenues and customers

Criteria	Option 1: Customer number wash-up	Option 2: revenue wash-up	Option 3: Revenue adjustment with two year lag adjustment	Option 4: no adjustment
Customer benefits				
Company financeability				
Consistency with final determination and other relevant documents				
Risk of perverse incentives				
Company ownership and accountability				
Consistency with other reconciliation tools				
Straightforward and clear to implement				
Preferred option	×	✓	×	×

A5.3 Treatment of time value of money

Differences between allowed and outturn household retail revenues can occur throughout the price control period. This raises similar issues to the totex sharing and wholesale revenue forecasting incentive mechanisms in terms of the time value of money in that there will be a timing between when the revenue over- or under-recovery was achieved and when this is reconciled at the end of the period.

Consultation document

Given the presence of a wash-up mechanism at the end of the period, we expect any differences between allowed and outturn revenues to be small. We therefore proposed that a time value of money adjustment should only be made if differences were material. We did not consider that it would be appropriate to set out the definition of material at this stage to ensure companies are incentivised to accurately match allowed revenues in each year.

Consultation responses

There was no consensus on this proposal.

- South West Water, Affinity Water and Bournemouth Water agreed with the proposed approach.
- CCWater and Southern Water both agreed with the proposed approach but considered that we should define the level of materiality.
- Anglian Water, Thames Water and Yorkshire Water all disagreed with the proposed approach and considered that there should be a time value of money adjustment and this should not be subject to a materiality threshold.

Our decision

We continue to consider that there is a good case for applying a time value of money adjustment, consistent with the approach used for other mechanisms. However, differences in household retail revenues are likely to be small, as the mechanism automatically adjusts for customer numbers. As a result, we consider that it is appropriate that a time value of money adjustment is only applied where differences are material.

We have reconsidered whether we define the level of materiality. On reflection we consider that it would provide greater transparency to water companies and their customers to set out a threshold where a time value of money adjustment would apply. We consider that a 2% materiality threshold should apply, consistent with the materiality threshold for a penalty in the WRFIM mechanism.

So, for the reasons outlined above, we consider that **a time value of money adjustment should apply where differences exceed 2% of household retail revenues**[31].

A5.4 Treatment of taxation

The reconciliation of household retail revenues in PR19 will present similar issues to the WRFIM in that we will need to consider whether to apply a taxation adjustment to the reconciliation of revenues in PR19.

Consultation document

In the consultation, we stated that a taxation adjustment should not apply to household retail revenues as revenue allowances for the 2015-20 period already include an allowance for tax which is payable on those revenues. If a company recovered less than its allowed revenue, it would make less profit and therefore pay less tax. At the next price control, the allowed revenues would be adjusted up to reflect that revenues were under-recovered in period. If this adjustment to revenues is given a tax allowance in the next price control, then the company would effectively receive an allowance for tax twice on the same revenue.

[31] For the avoidance of doubt, this is revenue attributable to household retail activities as set out in the final determination letter to companies.

Consultation responses

We received eight responses to the tax adjustment proposal. Six agreed with the proposal and two disagreed (Thames Water and Affinity Water). Thames Water was concerned that not applying a tax adjustment would put companies at risk if there was a tax rate change during AMP6. Thames Water considered that this could be avoided by making ex ante and ex post tax adjustments. Affinity Water considered that the proposed approach neglected the equal treatment of over and under-recoveries.

Our decision

We have considered the issues raised by consultation responses.

- **Differences between ex-ante and ex-post tax rates.** Consistent with the approach used for other reconciliation mechanisms, we consider that companies will benefit from reductions in corporation tax during the period, we therefore do not consider that we should protect companies from changes in the tax system which will impact on the allowances set at the next review.

- **Equal treatment of under- and over-recovery.** We consider that not applying a taxation adjustment provides equal treatment to over and under-recovery of revenues. If a company over recovered revenue in 2015-20 then it would pay more tax. At the next price control it would receive a revenue reduction equal to the over recovery – but in our price control financial model this would not affect the calculation of its tax allowance. As the company would receive less revenue in 2020-25 it would pay less tax – which would broadly compensate for the tax paid in the 2015-20 period. The opposite would be true if the company under-recovered revenues.

Based on the reasons set out above, we continue to consider that **we should not include a tax adjustment on the revenue changes that result from household retail in PR19 is the most appropriate approach**.

Table A5.2 Assessment of options for the treatment of tax on household retail revenues

Criteria	Option 1: Adjust tax for household retail revenues	Option 2: Do not adjust tax for household retail revenues
Customer benefits		
Company financeability		
Consistency with final determination and other relevant documents		
Risk of perverse incentives		
Company ownership and accountability		
Consistency with other reconciliation tools		
Straightforward and clear to implement		
Preferred option	×	✓

Appendix 6: Other issues

A6.1 Introduction

This appendix sets out other issues that are relevant to the PR14 reconciliation or that have been raised during the consultation, in particular:

- land sales;
- shadow RCV;
- non-household retail;
- interim determinations of K (IDoKs) and
- gain sharing mechanisms.

A6.1 Land sales

In the consultation, we stated that we intended to continue the approach first used at PR94 where we deducted 50% of the net proceeds of qualifying land sales from the RCV.

Severn Trent Water stated that the treatment of land sales should be made consistent with other mechanisms; which would involve:

- calculating a real adjustment to the RCV using actual RPI to deflate back to 2012-13 prices; and
- applying the real WACC from the period when any financing benefit is earned by the company (that is, the WACC for AMP6).

Year by year, the shadow RCV should reflect the actual net value of disposals at outturn prices, with financing benefits taken into account at PR19.

We consider that land sales are now much lower than the levels seen in the immediate period following privatisation. We are not minded to change the methodology in this area given that only one company raises this as an issue and the impact on the RCV appears modest.

A6.2 Shadow RCV

The rulebook did not set out how the shadow RCV should be calculated.

Severn Trent Water stated that the detail of the shadow RCV calculations should be set out (ideally in a published model) in time for annual reporting in 2016.

We consider that the calculation of the shadow RCV is a matter for the regulatory accounting guidelines which set out the reporting rather than reconciliation arrangements. The regulatory accounting guidelines for 2015-16 will be published later this year.

A6.3 Non household retail

The reconciliation rulebook did not set out how we would reconcile non-household retail revenue.

Severn Trent Water stated that the reconciliation rulebook should set out what would happen if a company over collected non household retail revenue. Severn Trent Water proposed that this should include materiality thresholds when Ofwat would consider investigations and enforcement action and companies should be able to propose and agree remedies with its CCG to avoid an expensive investigation process.

A reconciliation for non-household retail is not necessary as we set default tariffs. If a company breaches these charging obligations then we would consider enforcement action. We consider that our earlier statement on this matter provides companies sufficient clarity on when we would consider an investigation, as follows.

> **"Depending on the size, nature and reasons for the non-compliance, we may consider undertaking enforcement action where appropriate. This is for companies to manage as per their Licence conditions and other legal duties."**

A6.4 Interim determinations of k

The reconciliation rulebook did not set out how the IDoK mechanism would apply or how it would impact on the PR14 reconciliations.

Severn Trent Water stated that while it recognised that IDoKs were not necessarily a reconciliation rulebook issue it would welcome further clarification around how the IDoK process will work with the AMP6 framework.

While we consider that the IDoK process is not a part of the reconciliation rulebook, we consider that it is helpful to set out our views on the items listed by Severn Trent Water.

Severn Trent Water	Our response
The move to totex - which should not change the net present value calculation of opex over 15 years	Part IV (Interim Determinations) of licence condition B (Charges) sets out the process for calculating the materiality amount in relation to interim determinations. Where relevant, the net present value of revenue and/or operating expenditure is calculated over 15 years.
Qualifying items for an IDoK remain notified items or other relevant change of circumstance. The impact of ODI rewards and penalties should not be the subject to claims and counterclaims.	As set out in part IV (Interim Determinations) of licence condition B (Charges), qualifying items for an interim determination are relevant changes of circumstance and notified items.
All claims will be subject to normal triviality and materially tests. For this purpose, they will be valued at 100% of qualifying costs, regardless of the customer sharing mechanism which will subsequently be applied. Any successful claim should be applied in line with the agreed FD sharing rate in period. In the case of our only notified item, cumulo rates, the sharing rate is 75:25, therefore 75% of any qualifying costs would be borne by customers.	Part IV (Interim Determinations) of licence condition B (Charges) sets out the process for calculating the materiality amount in relation to interim determinations and any changes to price controls. All relevant items will be subject to the same triviality test. The costs or savings attributable to the notified item for water business rates will for each Charging Year comprise the product of the formula set out in the annex to the formal notification of Ofwat's PR14 determination. In relation to qualifying costs, this is the additional water business rates costs above the baseline assumed in PR14 multiplied by the water business rates sharing factor (75% for Severn Trent Water) minus the menu sharing rate.

A6.5 Gain sharing mechanisms

Four companies, South West, Sembcorp Bournemouth, Sutton & East Surrey, and Bristol Water are implementing gain sharing mechanisms. Throughout the price review process we have consistently stated that these mechanisms should not impact on incentives for companies to seek efficiency gains in the 2015-20 period.

It is evident that these approaches have the potential to impact on other parts of the regulatory framework, particularly the WFRIM and totex menus, but that there should be practical solutions which would allow them to work side by side.

For the avoidance of doubt, it is the responsibility of the companies to ensure that gain sharing mechanisms do not cause issues with the operation of the other mechanisms as specified in the reconciliation rulebook. We are happy to engage constructively with companies as they work through their respective implementation plans.

Appendix 7: Responding to the consultation on WRFIM issues

We have not made a final decision on the reconciliation of the wholesale revenue forecasting incentive mechanism (WRFIM) as we have identified an issue on the consistency between the WRFIM formula and the licence. So, we are inviting views on:

- the potential drafting for a licence modification to allow the licence to be consistent with the original WRFIM formula;
- whether companies would support such a licence modification; and
- whether we should:
  - use the revised WRFIM formula for all companies;
  - 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); and
  - only introduce a sector-wide licence modification if all companies agree to the proposed change.

Please email responses to: PR14reconciliation@ofwat.gsi.gov.uk.

The closing date for the consultation on this issue is **10 August 2015**. We are not inviting views on the other aspects of the PR14 reconciliation, where this document sets out our decision on these issues.

We will publish responses to this consultation on our website at www.ofwat.gov.uk, unless you indicate that you would like your response to remain unpublished.

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with access to information legislation – primarily the Freedom of Information Act 2000 (FoIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004. If you would like the information that you provide to be treated as confidential, please be aware that, under the FoIA, there is a statutory 'Code of Practice' which deals, among other things, with obligations of confidence.

In view of this, it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that we can maintain confidentiality in all circumstances. An automatic

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